DS Smith

Duropack and Trading Update Conference Call Transcript

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Speaker key

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AL	Alexander Mees
BD	Barry Dixon
JJ	Justin Jordan
HP	Harry Phillips
OP	Operator

MR Good morning everybody and thank you very much for taking the time to attend this call; I'm Miles Roberts, I'm the Group CEO and I'm joined on the call by Adrian Marsh, the Group Finance Director. I'd like to run through two areas today, firstly the proposed acquisition of Duropack and secondly an update on current trading. So I'm referring to the presentation that's been sent out and on our website – Proposed Acquisition of Duropack.

So as you know, our ambition is to continue to lead the recycled corrugated packaging industry. Packaging has never been more relevant to our customers and it's an ideal time for us to continue to develop our business and this acquisition is a further important step in the delivery of that strategy. The acquisition of Duropack, who are the market leader in South East Europe, is a highly complementary business to ours, and I'll talk more about that later. It gives us immediate scale in this region and, very importantly, access to a new customer base as well as providing additional services to our current customer base.

The acquisition is for approximately €300 million and will be funded from debt facilities, and represents a multiple of 7.3 times EBITDA from the last 12 months. It will be immediately EPS accretive, and very importantly will be above our cost to capital in the second year of ownership and go on to achieve financial returns fully in line with our previously stated medium term targets.

So turning to the next slide, we see just what an excellent geographic fit it is with our existing business. It overlaps with our current business in Austria, Czech and Hungary where we already have good, well performing businesses and it gives us an excellent position in other countries where they currently enjoy a number one or number two status. This region enjoys higher growth than the average for the rest of Europe. The outlook for the coming years is for the economies to grow at 2.6% per annum but very importantly the consumption of corrugated per capita is considerably less than half the average for the rest of the European Union and the combination of these two, we believe, provide a great platform for future growth.

Duropack has a long corrugated/short paper position which is important to us. The short paper position gives us flexibility to supply our customers with the packaging they need, not merely to fill up mills that we have. And it has a good recycling position, again an area that we feel we can significantly grow and develop to bring the recycling rates in this region up to those of the rest of Europe. It expands our pan-European footprint, not only enabling us to supply our existing customers but to start to service customers in that region, and this will all be supported by continual roll-out of our Design Centres which are so well received by our customers.

Turning to the next slide on the financial rationale, we can see that the sales are €273 million in 2014 which gives a return on sales of 8.1% and an EBITDA margin of 15%. We've had very good access to this business for a long period and the assets are well invested and we don't see any bubbles of capex needed in the future.

On the synergies, there are €12 million of cost synergies mainly around operational improvements, procurement and distribution. These have all been built up from the access we have plus also relying on the strengthened Group functions that we've built over the last few years. They will cost about €13 million to achieve but this will all be funded by improvements in working capital with a similar amount that we've also identified. So as I said previously, it's immediately EPS accretive. Return on capital will be in excess of the cost of capital by the second year.

In terms of the competition clearance, because the majority of it is in a new region, we don't foresee there being any significant issues here. We expect to obtain this clearance towards the end of Q2 2015 and completion will take place shortly afterwards. In terms of the confidence and integration, as I've said previously, we've had good access to this business. We've had extensive discussions with all of the management there, how it's structured, their processes and this will be integrated by the same teams that integrated SCA Packaging and Otor as well - a highly experienced team.

Turning to current trading, the volume performance over the three months to the end of January has been very good. It's been ahead of the H1 run-rate, it's been positive in all regions and Central Europe has been very strong indeed as well as in Italy. The reaction to the roll-out of our Design Centres has been absolutely tremendous so we're delighted with that. And this has reinforced our message on the importance of packaging to our customers, helping them sell more products through the retail chain, taking out cost and reducing risks.

We continue to manage our asset base. We also completed the disposal of the Nantes paper mill. The customer reaction to the Andopack acquisition, the business we bought in Spain a few months ago, has been absolutely tremendous. We are delighted with the performance there. So you can see how we continue to manage our asset base. Over the last few years we've sold Spicers, the office products business, we've sold the non-core assets of SCA, raising over €100 million, we've sold foam businesses in plastics, we're selling paper assets but at the same time we've bought Otor in France, SCA Packaging, Andopack Packaging and now we hope to acquire Duropack. It's all about how we continue to improve the asset base from which we earn our returns.

So with all of that, our outlook remains positive. Our performance has been in line with our medium term targets despite the mixed economic conditions, and that gives us confidence for the future. That ends our short presentation this morning and now myself and Adrian will be very happy to take any questions people have.

DOB Hi guys, just a couple from me please. Firstly, just on the 8% margin of this business, could you put that in context of where it trades historically; are we at the upper end of the band? And with such deals and obviously returns on paper look very good, is there an upside to your 12-15% ROACE target or your own return on sales targets in the next couple of years? And are there potential disposals of any of the paper mills within the business as well?

MR So Adrian, do you want to take the question on the return on sales and our medium term targets?

AM Sure. In terms of getting good visibility on the return on sales, David, clearly the business has been going, over the last few years, through a number of restructurings and reworks as the company is looking at likely disposal. From having run through the due diligence we're very comfortable where the returns are, the margin they're getting and how they're getting there. We don't think that on a comparable basis it's necessarily at the upper end or at the lower end. We think it's a reasonable margin being achieved in a competitive environment. The advantage the business has is the locations where they're in and their market positions. So we're quite happy about that.

MR And in terms of the paper mills, the number of paper mills this business has has been reduced significantly over the last few years. We feel the assets they have there are fit for purpose and we're not foreseeing any immediate requirements to reduce the paper capacity in this business. When we turn to ourselves, we constantly review all of our assets and at any one time we'll be looking to see how they fit going forward. And if we find that it isn't the case then we'll be looking to dispose of them or close them down. And those reviews are ongoing.

DOB Great. And maybe just one final one, just in terms of focus of the customer base, is it very much in line with DS Smith in terms of a FMCG focus or what is the breakdown?

MR As you go further East there's less straight in FMCG and there's more of a light industrial bias. So if you go back to the original part of DS Smith, we are over 60% FMCG and that really just mimics the sorts of economies that we're in. As we go further East it comes down to more than 50/50. However, the market shares that this business enjoys, we think we can grow the FMCG business quite considerably, exactly as we continue to do with the SCA and that Otor business. So we feel very confident about that. We do have to improve that proportion and we're looking to take that from the market share.

DOB That's great. Thank you very much.

AL Thanks. Good morning Miles and Adrian. Three brief questions please; the first one with regard to your customers, have you engaged with your customers about this acquisition at this stage and if you have, what's been their reaction? The second is around the synergies; I wonder if you could just put into context the size of the synergy opportunity compared to your acquisition of SCA and Otor and if there's any reason that you would expect ultimately the synergies to be significantly higher or lower than those. And then just thirdly, on the trading updates, clearly you've had quite a significantly adverse FX movement over the course of the year and given the size of that headwind, we haven't seen consensus numbers come down significantly. If consensus is more or less correct then to what do you attribute the improvement to the underlying business please?

MR If I answer, Alex, on the customers then Adrian will take you up on the synergies and the FX and the trading update. So just in terms of customers, it's obviously very difficult to talk to any customer about a potential acquisition. It's just because of confidentiality. However, we have extensive discussions, reviews with all of our major customers on a regular basis and in these discussions it's absolutely clear from them about their desire for us to continue growing. So when we bought into Spain, their reaction was absolutely tremendous. They wanted a different offering there and we are able to give it to them. In Eastern Europe and Italy and in the DACH region we've had tremendous growth out of the SCA acquisition. Now, we recently announced an acquisition or a proposed acquisition in Greece and Turkey and again the customer reaction was very strong. So we'll be talking to our customers; today in fact there's communication happening now to our existing customer base about what it means, how we're going to continue rolling out our unique approach and I've no doubt at all there'll be a tremendous amount of support coming to us.

Adrian, now the synergies and trading update?

AM Yes. In terms of synergies I think they're around about 4% of sales, Alex. If you look at SCA, if you look at Otor, from announcement to realisation it's right within those ranges as well. So we're very confident, we know what we're doing, the team are the same. We're looking obviously at procurement, we're looking at operating in line with DS Smith best practice and ways of working and we're obviously looking at operational efficiency as well. So the number we've declared, based on the due diligence we've done to date, we think is robust, stands up to previous acquisitions and we're very confident of delivery.

In terms of underlying trading, we've seen good volumes. We're happy with where that's progressing. Of course FX continues to be a disappointing outcome for us in terms of how we translate our substantial overseas operations back into sterling. But in terms of the underlying business, the front end is operating very well, we're getting good traction in terms of the customers that we're looking to operate with, we've had the SCA synergy benefits falling through, we're seeing the continuation of the improvement in the UK from the Kemsley turnaround plan, so everything that we've had that's been within our gifts, certainly within the corrugated packaging side, we're quite happy with our performances. But we have to fight extremely hard to keep our head above water at the level of growth we want to, on a translated basis; that there's no doubt about. But clearly when we get to the full year we can give you full colour on everything. At the moment underlying in Continental Europe, we've got volume growth, we've got the benefit of activities we've taken to manage our cost basis and optimising our efficiency and we're very encouraged with what we're seeing. There's probably not a huge amount more at this stage I can say.

AL That's super. Thank you very much, Adrian, thank you Miles.

BD Good morning gentlemen, and congratulations on the deal. Two questions if you wouldn't mind; just in terms of the average price, if you take the 273 million of revenues, presumably you sold roughly 300,000 tons of corrugated and on a net basis about 70,000 tons of containerboard, if you put it at a price of €450 a ton for a containerboard, it implies a price of somewhere around €700 a ton for corrugated. Do you think there's scope here to increase that corrugated price structurally over time or are there reasons why prices in that part of the world might be lower?

The second question is just really on technical things around what kind of funding costs, Adrian, should we assume in this and also what kind of tax rate should we assume? Thank you.

MR Barry, on the first one, what we are seeing in our core business, our margins are growing. It's obviously a very difficult time but we're seeing we can continue to grow our margins quite successfully through more added value. And I've absolutely no doubt we can do that in Duropack. The average price for corrugated is lower than in the rest of Europe, not only because there's lower added value but because the way it's rewarded, is paid for is slightly different. One thing which you've got to bear in mind is about the degree of integration here and the degree of integration in this business is higher than we have in DS Smith. So again, just how you price for the paper in the turnover and how it comes through into packaging we'd have to outline at a later stage. In answer to your question, I've absolutely no doubt we can add value here. I know there are discussions with customers going on this morning, they'll be looking for exactly the same way that we work in the rest of Europe and it's up to us to bring that out.

AM On funding, Barry, because we're going to be drawing out of existing facilities, if you just work with the blended funding costs that we've had to date, you're not going to be a million miles wrong. Clearly we've deleveraged a bit and we'll flip it back again as we go through next year. But in terms of what you've currently got, it's going to be there or thereabouts. And similarly on tax, at the moment there's no reason to assume that it will tick up our overall tax rate. A number of the specific country rates will be slightly higher than our Group rates and there are some losses in the business as well that we'll be utilising, so at this stage I'm not proposing any change to our guidance on tax.

BD So 24-25%, Adrian, kind of thing?

AM 23% is what we guided at. So I'm not seeing any change in that. Possibly three to five years down the road there could be some changes as that business grows and those relative country tax rates remain slightly higher but at this stage we don't see anything at all that will impact our overall tax charge.

BD And a blended interest rate of about 4% or thereabouts?

AM Yes, that's exactly what I would use.

BD Okay, perfect. Thanks a million, guys. Well done.

JJ Good morning guys and well done on the acquisition. Can I just take a step back and talk about the current trading element of the statement this morning? You talked obviously about the volume performance in the three months ending January being ahead of the 2.3% you achieved in the first half. Are we to infer that margins in Q3 were similarly ahead of the 8.9% operating margin that you achieved in the first six months? And secondly, it's probably a geeky analyst question but presumably you're going to be reporting Duropack within the Central Europe and Italy portion of the Group going forward? And thirdly, can you just comment on the €40 test line price increase that you've announced from the 1st March and just explain your confidence in achieving that and just the thinking behind that and the reaction you've had from customers thus far?

MR Adrian, if you would take the reporting. Just in terms of the margin, in the second half of the year we typically have a lower margin than in the first half and it's all to do with the build up for Christmas and the harvest and summer period which is very busy for us. So the margins in the second half are traditionally below those in the first half. However, what we're seeing on a comparative period, if we go back to previous year, then our margins are doing better. And the higher volumes, obviously we get some operational leverage coming through this. That's really a lot behind what Adrian was saying about the currency; the underlying trading is going well.

The €40 we've announced, this is partly the other side of this FX, the euro has weakened considerably against other currencies and therefore the cost of imported paper is rising and of course the price of our exported paper has been falling. So these FX movements have given some support to the paper price and I have to say, you can see from our volumes, our mills are busy. We are busy on paper. So all of that has gone to support the increase we've announced.

AM On the second question, will it be in Central Europe and Italy - the answer is yes.

JJ Okay, and just a very brief follow up to that, your existing operations in, so you talked about having businesses currently in the region as it were; what are the revenues that you currently have in Austria, Czechoslovakia and Hungary for the DS Smith Group, just to put some of the immediate synergies into context?

AM As far as I'm aware, Justin, we don't separately disclose those but they're not going to be huge.

JJ Okay, great. Thanks.

HP Good morning everyone; a couple of questions please. Just in terms of, you already mentioned in passing Greece and Turkey, if you could maybe just provide an update of how that process is going. Just looking elsewhere at your map, Romania would strike me as being the next obvious place to go. Is there anything maybe more Andopack size that could be on the horizon? And then just lastly on the debt structure, I see there's seven million of interest in the acquisition, so is this circa 130 and then170-odd million of debt in the business or am I guessing that maths is quite wrong? I suppose what I'm trying to ask is how much debt is in the business at the current time?

MR So again if I take the first two and you'll pick up on the interest, Adrian, and the debt?

AM Yes.

MR So Turkey and Greece; as you know we already own part of that business and we've been going through all the due diligence work and that's well advanced. There is always discussion about value and what these businesses are worth but that's coming along quite nicely. We haven't assumed any benefit from tying up that business with Duropack because we don't own it yet. Discussions are going well. You mentioned about Romania. We already have a business in Romania, in Timisoara. The Romanian market is a reasonable market. There are some opportunities there but there's nothing that's active. We've already got a good position there. If things come up we'll have a look at them but they aren't of any great size or significance.

AM On the debt side, Harry, when we look at an acquisition we look at the debt that's currently got interest charged on it and there'll be a stack of items that we also consider debt or debt-like. When we're looking at this roughly two-thirds of the enterprise value is debt or debt-like and a third is equity value, roughly. However, clearly we're going to have to finance the whole thing so whatever is currently interest bearing we will refinance. And so the easiest way to look at it, and the way we certainly, as simplistic folk, will look at it is that we're going to refinance the whole €300m at our blended debt cost.

HP Fantastic. That's very helpful.

MR Well thank you everybody for your time this morning on the call. A couple of things; we're obviously delighted to have announced this proposed acquisition. We've had good access to the business, the synergies are good, the team that we have to integrate this is the team that's done the other work and all of that gives us real confidence that we can make this acquisition really very, very exciting. And aligned to that we see the continued growth of our current trading, the volumes are going well, we're getting the benefits from that but obviously we are very mindful of the foreign currency translation effects that are playing out.

Thank you very much everybody for your time.