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## Research Update:

# U.K.-Based Paper Packaging Producer DS Smith 'BBB-' Ratings Affirmed; Outlook Stable

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## Research Update:

# U.K.-Based Paper Packaging Producer DS Smith 'BBB-' Ratings Affirmed; Outlook Stable

## Overview

- U.K.-based paper packaging producer DS Smith has made several acquisitions over the last 12 months, resulting in higher debt and more exceptional costs than we had anticipated. However, we expect DS Smith will integrate these acquisitions successfully, resulting in improved earnings and rapidly recovering credit metrics.
- We are affirming our 'BBB-/A-3' ratings on DS Smith as we expect adjusted leverage to recover to below 3x in 2016 and forecast funds from operations (FFO) to debt to increase to above 30% over the next 12 months.
- The stable outlook reflects our view that DS Smith will continue to grow its earnings and generate substantial positive free operating cash flow over the next two years, despite the sluggish operating environment in its main European markets.

## Rating Action

On March 29, 2016, Standard & Poor's Ratings Services affirmed its 'BBB-' long-term and 'A-3' short-term corporate credit ratings on U.K.-based paper packaging producer DS Smith PLC. The outlook is stable.

## Rationale

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

With its recent acquisitions, DS Smith has comprehensive pan-European coverage. That said, it lacks the access to high-margin, low-cost emerging markets of peers such as Smurfit Kappa and Mondi. With its focus on higher-volume and lower-margin customers, as well as on its lower-margin recycling segment, DS Smith's Standard & Poor's-adjusted EBITDA margins are weaker than its packaging peers'. The recycling segment is nevertheless strategically important for supplying recycled fiber to DS Smith's mills and box plants. The company relies on client proximity with its closed-loop

operating model, whereby it collects and recycles cardboard boxes from retailers. The company's relatively low absolute profitability is partly offset by the relative resilience of its FMCG packaging end-markets, translating into what we view as fair volatility of profitability through the economic cycle.

Our business risk assessment incorporates our reclassification of the group as being in the containers and packaging industry rather than in forest and paper products. Although DS Smith has significant backward integration in recycling and paper production, the group remains net short in paper--a position we believe will deepen over time as its share of packaging sales increases with no new paper capacity expected. The group's short position in paper means that DS Smith is somewhat exposed to volatile testliner prices. However, this is partly mitigated by a proportion of sales with contractual cost pass-through mechanisms as well as the group's strategic vertical integration in paper.

DS Smith has strong cash flow generation, which we believe will help credit ratios recover quickly after moderate debt-funded investments. We expect that the group's financial policy will remain unchanged with dividend payouts, calculated as a ratio of earnings to dividends, of 2.0x-2.5x over the cycle. These factors support our assessment of its intermediate financial risk profile.

In our base-case for DS Smith, we assume:

- Underlying organic revenue growth (excluding foreign-exchange effects and acquisitions) of about 3%, broadly reflecting our forecasts for eurozone GDP growth and inflation.
- Acquisition spending of up to £200 million annually, which could push revenue growth into the low double-digits.
- Slight margin improvements toward 12%-13% (excluding exceptional and restructuring costs), reflecting growth in higher margin packaging segments and a smaller share of lower margin paper and recycling.
- Annual capital expenditure (capex) continuing at a little above 4% of revenues.

Based on these assumptions, we arrive at the following credit measures for DS Smith:

- Adjusted debt to EBITDA increasingly slightly to about 2.6x in 2016 from 2.3x in 2015, and improving thereafter toward 2.0x-2.3x.
- Adjusted funds from operations (FFO) to debt slightly below our expectations for the rating at around 28% in 2016, recovering to above 30% thereafter.

### **Liquidity**

The short-term rating on DS Smith is 'A-3'. We assess DS Smith's liquidity as strong. We expect the company's liquidity sources to exceed its uses by more than 1.5x over the next 24 months, supported by healthy cash balances and full availability under its committed revolving credit facility (RCF), with headroom under its covenants of over 30%.

We estimate DS Smith's principal liquidity sources for the next 12 months as:

- About £140 million of cash that we consider unrestricted as of Oct. 31, 2015;
- Access to a largely undrawn committed RCF of £800 million; and
- Our forecast of cash FFO of about £450 million.

This compares with the following liquidity uses for the same period:

- Short-term debt of £205 million as of Oct. 31, 2015;
- Expected dividend distributions of about £100 million-£120 million;
- Working capital swings of about £100 million;
- Capex of about £170 million-£190 million; and
- Our forecast assumption of acquisition spending of up to £200 million annually.

## Issue Rating Analysis

We apply our structural subordination analysis to DS Smith's euro medium-term note program and its senior unsecured bond issuance. Although there is no significant prior ranking financial debt in the capital structure, the company has sizable trade payables that we effectively view as senior. Our concerns about structural subordination are mitigated by substantial pari passu intercompany loans made to subsidiaries, the group's significant diversity, and efforts to increase group procurement at the PLC level.

## Outlook

The stable outlook reflects our view that DS Smith will grow its earnings through successful integration and synergies from its recent acquisitions, and continue to generate substantial positive free operating cash flow over the next two years, despite an ongoing continued sluggish operating environment in its main European markets. While we expect the group to remain acquisitive, we believe that credit metrics will stabilize within the intermediate financial risk profile category.

### Downside scenario

We could consider a negative rating action if DS Smith experienced severe margin pressure or weaker cash flows than we anticipate, leading to weaker credit metrics--for example, debt to EBITDA of more than 3x, and FFO to debt below 30% on a sustained basis. If DS Smith changed its financial policy to accommodate significant debt-funded shareholder distributions or larger-than-expected acquisitions, without suitable mitigants, we could also consider a downgrade.

### Upside scenario

We consider ratings upside to be limited in the short term due to DS Smith's growth-target policies, which we believe will limit material deleveraging. However, we could consider raising the ratings if we believed that DS Smith

could sustain debt to EBITDA at the upper end of our intermediate financial risk profile category, specifically, FFO to debt exceeding 40% and adjusted debt to EBITDA of about 2x.

## Ratings Score Snapshot

Corporate Credit Rating: BBB-/Stable/A-3

	To	From
Business risk:	Satisfactory	Satisfactory
Country risk:	Low	Low
Industry risk:	Intermediate	Moderately high
Competitive position:	Satisfactory	Satisfactory
Financial risk:	Intermediate	Intermediate
Cash flow/Leverage:	Intermediate	Intermediate
Anchor:	bbb-	bbb-
Modifiers		
Diversification/		
Portfolio effect:	Neutral (no impact)	Neutral (no impact)
Capital structure:	Neutral (no impact)	Neutral (no impact)
Financial policy:	Neutral (no impact)	Neutral (no impact)
Liquidity:	Strong (no impact)	Strong (no impact)
Management and		
governance:	Satisfactory (no impact)	Satisfactory (no impact)
Comparable ratings		
analysis:	Neutral (no impact)	Neutral (no impact)

## Related Criteria And Research

### Related Criteria

- Criteria - Corporates - Industrials: Key Credit Factors For The Containers And Packaging Industry - November 19, 2013
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- Criteria - Corporates - General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers - December 16, 2014
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments - November 19, 2013
- General Criteria: Group Rating Methodology - November 19, 2013
- Criteria - Corporates - General: Corporate Methodology - November 19, 2013
- General Criteria: Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers - May 07, 2013
- General Criteria: Methodology: Management And Governance Credit Factors

For Corporate Entities And Insurers - November 13, 2012

- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue - April 15, 2008

## Ratings List

Ratings Affirmed

DS Smith Plc

Corporate Credit Rating

BBB-/Stable/A-3

Senior Unsecured

BBB-

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Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at [www.standardandpoors.com](http://www.standardandpoors.com) for further information. Complete ratings information is available to subscribers of RatingsDirect at [www.globalcreditportal.com](http://www.globalcreditportal.com) and at [spcapitaliq.com](http://spcapitaliq.com). All ratings affected by this rating action can be found on Standard & Poor's public Web site at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.

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