DS Smith Plc – Pre-Close Statement
27 October 2011
8:00am Greenwich Mean Time

Operator: *Welcome to DS Smith Pre Close Statement Conference Call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session. Please note that this conference is being recorded.*

I would now like to turn the call over to your host, Miles Roberts. Sir, you may begin. Thank you.

Miles Roberts: Good morning, everybody, and thank you for joining us today to talk about our Pre-Close Statement for the six months to the end of October. I'm Miles Roberts, the CEO of DS Smith, and I'm joined by Steve Dryden, our Finance Director.

So this morning, we released our Pre-Close Trading Statement, and I'd like to start by taking a few minutes to run through some of the highlights, after which Steve and myself will be delighted to take questions.

Before getting into some of the detail though, I'd like to start saying that we are pleased with the momentum and progress of the business through the first six months of the year. We are delivering on our strategic and financial targets with a strong contribution from Otor, the French packaging business that we acquired last year, and this means that we expect the half year to show significant EPS growth compared to the comparable period last year, and I would also like to flag that we're successfully completed a refinancing of our revolving credit facility with a new five-year £610 million facility.

So in terms of trading and looking at the Group as a whole, well the encouraging trading that we reported in September's IMS has continued. Like-for-like volumes in corrugated packaging are up 3% year-to-date against strong comparatives last year, and that momentum's continued right to the end of the current period. This performance primarily reflects the resilience of our FMCG, the fast-moving consumer goods customer-base that we've been focusing on. While everyone knows about the challenging economic situation, the fact remains that people continue to eat and drink and consume those FMCG products, and that's good news for DS Smith. And as well as seeing good like-for-like volume growth, we continue to make progress on margins, return on capital, and strong cash flows.

So now briefly running through some of the highlights of the packaging business. Well we continue to make excellent progress with regard to executing our strategy for this division. The focus on providing customers with high levels of service and quality and offering new innovative packaging solutions, which add value to their business, has allowed us to improve our margins. We're on track with our efficiency initiatives, with the initiative to reduce procurement costs will now deliver £9 million this financial year, split between opex and capex, and that's an improvement on the target of £6 million, which we've recently given. And as part of our strategy to reduce paper manufacturing, we sold the Higher Kings Mill, which produced 34,000 tons per annum. The process to close our Hollins Paper Mill, which produces 95,000 per annum, remains fully on track. And with regard to Spicers, our office products wholesaling business, well trading has been good there and - - the £2 million disposal remains fully on track to be completed by the end of the calendar year.

So the remaining business is now focused. Following the disposal, the remaining business is now focused on packaging, and we have the financial strength to invest in the business both organically and by acquisition.

And on the subject of M&A, it is worth reminding everyone that we'll only proceed if we expect the acquisition to result in returns to shareholders which are fully in line with our medium-term financial targets that we've outlined, and that's exactly what we've done with Otor.

And finally with regard to outlook, well DS Smith continues to get stronger as a business as we focus on our FMCG customers, reduce our exposure to paper, and instead have long positions in recycled packaging and the collection of fibre; and we expect to continue to make progress with regard to margin improvements, return on capital, and cash generation. And while taking into account the challenging macroeconomic environment, the Board remains confident in the trading outlook for the year.

Thank you. Steve and I are now very happy to take any questions that you may have.

Operator: *Thank you. We shall now begin the question-and-answer session. If you have a question, please press star then one on your touchtone phone. If you wish to be removed from the queue, please press the hash key or the pound sign. Once again, if you have a question, please press star then one on your touchtone phone. Please hold while we queue for questions. Thank you.*

Ross Gilardi from Bank of America Merrill Lynch is now online with a question.

Ross Gilardi: Good morning. Thanks, gentlemen. I just had a few questions. **First of all, can you comment at all on the trends in your Continental European margins year-on-year excluding Otor? So in other words, are the margins in your underlying, your legacy business also going up?**

Miles Roberts: They are. It does… Well first, good morning, Ross. It gets a little bit blurred in France because you've really integrated the original business with the Otor acquisition, but everything shows us that those businesses continue to make good margin progression, particularly as they all - - as in France, they benefit from some of the synergies with Otor, plus everybody's benefiting from the better procurement. Obviously there's an operational gearing effect as well as the packaging volumes come through. So in terms of the legacy business, that does continue to improve.

Ross Gilardi: Thanks, Miles. **And just in terms of the downdraft we've seen in container board prices, would you expect that to give a short-term at least margin benefit in the second half of the year or how should we think about that for the Company overall?**

Miles Roberts: As we know, we have a small paper, or rather a modest paper position and there's no doubt the price of testliner has come down. That obviously affects paper, but it's obviously a very modest part of our business, and that does lead to some short-term margin expansion. I think we've been very clear with our shareholders that we're trying to really reduce the cyclicality and that means reducing the trough. But also some of the spikes you may get in any one month in the past, that won't be the case or certainly not to such a degree, so we probably do see some short-term slight improvements in the margins. But when we're looking for the year as a whole, we don't expect there to be any substantial benefit, and it's quite interesting because the price of paper has fallen. The price of old corrugated cases remains high. Energy remains high. Fuel remains high, so overall there's still a bit of inflation coming through from other areas as well.

Ross Gilardi: Right. Thanks for that. **And then could you just compare and contrast maybe some of the trends you're seeing in the UK corrugated business versus the French corrugated business right now?**

Miles Roberts: Yeah, the makeup of the businesses is slightly different in that we have more FMCG in France. And broadly in the UK and France, in our FMCG business, they're both doing well. Retailers continue to demand more shelf-ready packaging from their supplies. I think everybody recognised we've got an absolutely super position in this market. We really are seen as leading the whole development there. So in both the UK and France, it's going very well. Now the UK outside of that does have a slightly higher proportion than France in terms of industrial. It's about 30% of their business whereas in France it's less than 20, and it's no doubt the industrial sector isn't developing at the same - - isn't growing at anywhere near the same rate as the FMCG, so that does mean the growth in the UK is slightly below France. But I stress, in terms of our core FMGC business, it continues to do better. It really does. We're pleased with it.

Ross Gilardi: **But is industrial still flat to up slightly or are you seeing negative trends on the industrial side?**

Miles Roberts: I mean on industrial, we've got 3% overall volume. It's quite a bit stronger than that in FMCG and industrials, it was zero to one, and it's been like that really for the last sort of quarter really, but frankly that's more or less where we expected it to be. Our outlook hasn't been for the industrial sector to show significant growth either this year or have to say next year, but that was all in our 3% target, so it's trading pretty much as we expected. Great growth in FMCG and very consistent. You see the orders come in every day because the people don't stop eating and drinking, and it's great to see them.

Ross Gilardi: Thanks, Miles. And then just lastly, Steve, I just had a couple of questions. **Can you give us a sense of what you think run rate annual and net finance costs are going to be post the Spicers divestiture once it's completed, and any thoughts on pension funding and costs going into next year?**

Steve Dryden: Yeah, okay. I'll just take your run rate costs, obviously we'll put those funds on deposit. We're not looking to cancel or prepay any of our private placement borrowings because of the - - I guess the outlook on terms of acquisitions that we've talked about previously and Miles has just reiterated on the call. So effectively we'll have the funds on deposit at, call it, a half percent. So what's in your models now in terms of financing costs still holds true and obviously holding those funds there for reinvestments certainly for the next 12/18 months. So that's where we are in terms of the models.

On pension costs, obviously your model, as most people got in, I think we guided to a charge of about £3 million. In terms of how the accounting works, that's really we're not the balance sheet, so you just need the model forward in terms of what you see the assets and liabilities. I think the interesting thing as you get into 2013/2014, there's a change in accounting coming on pension costs and there you're probably looking at an extra between £3-to-6 million of charge. Again, so finance charge related pensions is non-cash.

On the cash side, as you know, we reached agreement with a trustee on a ten-year recovery plan of which we pull forward one year as a result of the Spicers' disposal, so there's the ten-year recovery plan that goes to nine years but with £15 million going in against the Spicers' disposal proceeds.

Miles Gilardi: Thanks very much.

Operator: *Excuse me. Alexander from JP Morgan is now online with a question.*

Alexander Mees: Good morning, gentlemen. **Just thinking about your sales mix, it's obviously a fairly dynamic thing, paper manufacturing becoming a considerably smaller part of what you do and your income. I was just looking at your previous targets, the return on capital employed 12-15% over the medium-term. The question was: To what extent is that predicated on further evolution as a sales mix and to what extent will that be driven further acquisitions?**

Miles Roberts: Yeah, I mean the 12-to-15% is on our - - it's on our existing business. That's what we expect to make from it, and we saying year in/year out we should make returns in that range. And the reason that's so different from other people who sort of loosely associated with, but are the companies that have very long paper positions is that to keep that consistency we have - - we really need quite a modest paper position. So some existing business, but it is with a declining paper position to reduce the cyclicality.

Now when we look at acquisitions, we're not looking to dilute those returns. We're looking to consistently earn above our cost of capital from those investments. In our cost of capital, it's all pre-tax. It's more around the 10% level and therefore the acquisitions getting that 12-to-15% range, but that means that they themselves will need to be short on paper and long in packaging.

Alexander Mees: **So to clarify, we won't see a situation where you don't have any paper manufacturing capability, but it will become quite a small part of what you do and really the growth will be predicated on the FMCG side of the business.**

Miles Roberts: Yeah, we said that our mix of business that we do need some paper and that is - - and looking at the acquisition opportunities, we are looking - - all of the ones we're looking at are short in paper. They do have some, but it's a very modest part. It's really that packaging, recycled packaging business that we're after with the right level of paper to support that, which is quite a short paper position principally because there's excess capacity in Europe and that's what leads to that cyclicality of returns in paper, and there are a number of opportunities that we are looking at. But we're very, very clear on where the growth will come from and that's a continued use of corrugated recycled packaging by the big FMCG companies. The industrial clients as well are continually switching to this much more sustainable source of packaging. That's where we see long-term good growth opportunities and therefore good returns from our shareholders.

Alexander Mees: Thanks and thank you.

Operator: *Excuse me: Donal O'Neill from Goodbody Stockbrokers is now online with a question.*

Donal O'Neill: Hi, guys. Good morning. A few questions for me. **First of all, on the corrugated pricing side, what are your expectations given where - - we spoke about**

testliner prices coming down, what are your expectations for corrugated pricing in the second half of the year?

Miles Roberts: I mean testliner price of paper is - - it has fallen. It hasn't fallen hugely, but it has come off an all-time peak. It is still high, and we're actually still getting price increases coming through, although there's no doubt they're sort of trailing off now. That's price increases in our packaging coming through. So looking forward, I think if it continues at this level, there might be some small adjustment, but it's not tremendous. Really what happens with paper, this is a problem which we just know, and that's why we have such a short position in paper; and frankly with our packaging business if paper is high or low, we're still looking and are achieving the same profit for each square meter, each box that we sell, so it's high or low. We're not overly concerned about that because the value-add is what we're pricing on.

So in terms of the outlook for testliner in the short-term, I think it probably stay at or where it is, it may come off again very slightly. It's still very high. I have to say the price is still expensive, but really what happens after the next I'll say three months, I just have no idea. Personally I don't think it's going to fall very far, but we just don't know. We just don't know.

Donal O'Neill: Okay. **In terms of the negotiations with clients, and this is contrasting the industrial versus the FMCG, has there been a change in terms of the prices they're prepared to pay for corrugated?**

Miles Roberts: No, I mean if anything, we're doing an awful lot of work with our customer base, understanding their requirements in much more detail. I mean it's been absolutely fascinating. We've done a lot of work on the customer base with them and there's a lot of improvement that is possible here. We're nowhere near the end of it. And there is a real appetite for great packaging and that doesn't just mean the box or just the printing or just the colours and the ease of use, it's all about the supply chain and how it runs through their lines, how we deliver the service, stockholding, the transport costs, et cetera. It's a really quite exciting area and it's an area that I think we are good at, but we can be much, much better than that, and that continues to drive value and then it's back to how you price and how you charge for that. And again, that's an area which we have been doing a lot of work on, and I'm very encouraged by the progress that we're making. There's a bit of momentum building in the business behind a lot of the work that the people are conducting.

Donal O'Neill: Okay very good. **And just specifically in terms of the refinancing, what is the rate on the new facility?**

Steve Dryden: Should I take that, Miles?

Miles Roberts: Yeah, please.

Steve Dryden: Yeah, well obviously we don't actually disclose the specific rates, but this time - - last time and it's a - - so it's ratchet link to net debt to EBITDA, Donal. But if you think of it last time, it was less than 1.5. I think it was 120 basis points was the margin and we are slightly better than that this time.

Donal O'Neill: Okay that's great.

Steve Dryden: We concluded that before some of the banking turmoil that we're seeing in the market at the minute, so we feel as if we got in ahead of that in terms of the tightening. The pricing's starting to tighten up a bit.

Donal O'Neill: Sure. Great stuff. **Just one last question then, you mentioned acquisitions. Has the expectation for pricing on multiples you have to pay changed recently based on the sort of turbulence and the volatility we've seen in the market?**

Miles Roberts: Steve, do you want to take that?

Steve Dryden: Yeah, at the end of the day, high quality businesses are always attract good valuations, Donal, and the lower ones don't, and I think people's expectations don't change. Probably some of the loftier expectations people are realising because I think some of the competition from outside of trade buys is reduced in terms of private equity's ability to access low cost funding is certainly reduced, so it's a more balanced playing field for the trade buyers now.

Donal O'Neill: Great. Okay, that's all from me, guys. Thanks very much.

Miles Roberts: Thank you.

Operator: Excuse me. Harry Philips from Evolution is now online with a question.

Harry Philips: Good morning, everyone. A couple of questions please. **Just a little bit on the sort of FMCG performance elsewhere in here, you've highlighted France and the UK, Miles. I was just wondering, is FMCG pretty consistently in each region or is it higher or lower than some territories? And then secondly in terms of the recycling rollout, if you just sort of update there and how's that going please?**

Miles Roberts: Yeah, the thing about the FMCG is that a lot of the customers that we are working more with on a pan European basis and in some ways we sort of slightly follow their growth, so actually we go further east, it gets stronger. No, we've got very good position in countries like Poland, but they're just more modest in terms of the overall size of the group, but we see very good progress there and in Italy as well. So in the UK, France, Italy, and Poland, which are our main markets, we have taken share in every market; and in our joint venture in Ukraine, that's also doing well in that economy. So here I say, we are pleased with the progress in France and the UK. The economies aren't in the greatest of shapes, as you get to - - and indeed in Italy as well. But as you go further east, it actually gets slightly stronger I have to say.

In terms of recycling, we see this as not only a great short-term play, but a fantastic medium- and long-term position. Not only does it secure the fibre for us, and I think over the long-term ownership of the fibre or the critical raw material will be very important, but it gives us access to the retailer and the retailer is our customers' customer. So one of our FMCG customers, typically to sell to one of the big retailers, and this recycling allows us to work with the retailer and we work in a completely different way to other refuge or waste collectors. We look to maximise the use of corrugated in the retailer that takes cost out of the retailers operation and we also get them an income for the corrugated, and we're seeing that's really very exciting. That's probably even in the UK, it's the highest growth business we have. It's doing extremely well, and the rollout into Europe again is going very well. We are collecting just - - I think I've said before, we've secured all of Tesco's business in Eastern Europe. We have now started all of the collections and we are very pleased with how that's going, but it's early days. They aren't huge volumes. As we gear up and the interest expressed from other retailers on the continent, we are very pleased with, although I can't sort of announce any other major deals at the moment. We are very encouraged by the reception that we're getting to our offering, which really is quite unique. I'm very pleased with the rollout with Tesco.

Harry Philips: That's great stuff. Many thanks.

Operator: *Excuse me. Wayne Gerry from Investec is now online with a question.*

Wayne Gerry: Good morning, guys. Just four very quick questions. One for Steve. **Can you just tell us what the covenants are on the new revolver?**

Steve Dryden: Yeah, sure. They're exactly the same as the ones we previously disclosed, are the interest covered covenant and previously it was profit divided by interest had to be greater than three and now it's EBITDA divided by interest has to be greater than 4.5. Now frankly normally this never has an issue except I guess in your worst downside scenario where it's actually being an EBITDA basis because a business such as ourselves greater headroom.

Wayne Gerry: Right, okay. The other question is: **Just on the plastics where you were saying that that's had good growth, volume growth, can you give you a bit more colour as to the two activities and where the growth has come from?**

Miles Roberts: Yeah, plastics is primarily liquid packaging and dispensing, and this is around the plastic bags that you pour liquids in and then that bag goes in a corrugated box and…

Wayne Gerry: **So it's that rather than the returnable crates that's driving the growth?**

Miles Roberts: That's the major part of it and they're also growing. Where we've really been focusing, I mean we're getting very strong demand there and we see a long-term significant growth opportunity here. As you know, we are opening a new factory at the moment in Thailand, unfortunately it's near Bangkok, but it's well above the water level. We did have a good look at that beforehand. But it's the demand for these bags that go into boxes because it saves so much on transport, transporting a box rather than in a bottle or a drum is - - has been and remains very strong, and I think we're going to see continued good growth in that market. But again, we're sort of tidying out the portfolio doing along the cost base, so we're seeing very nice profit growth.

Wayne Gerry: Okay. Just two final quick questions. **On the timing on the cost savings or the procurement savings coming through, what's accelerated that, and has there been any change in the timing of general cost recoveries?**

Miles Roberts: Steve, do you want to take the part on procurement, et cetera?

Steve Dryden: Yeah, it's really actually still there in terms of on procurement if you think back to where we last spoke to you where we talked about £6 million.

Wayne Gerry: Yeah.

Steve Dryden: They're looking to achieve £9 million in this current financial year. It's coming across all the spend categories.

Wayne Gerry: **Okay, so it's a bit on everything. It isn't something specific**

Steve Dryden: Yeah, that's right if you think back to that organisation structure, that we probably showed last December, it's very much individual businesses doing the best job they could to buy. We appointed an interim while we recruited a permanent chief procurement officer. He's now in place and it's good… I guess it's good procurement disciplines combined with aggregating spend across the whole Group combined with, in a sense, supplier size, and the visibility of the size of their customer and the confidence in things like credit and that and also it's a growing customer and then wanting to support us, so it's really those three things that are driving the procurement benefit.

Wayne Gerry: Okay. **And in terms of recovery of the input costs, Miles, is there anything of note to add there?**

Miles Roberts: No, I mean I'd say our recovery has been good. Fully recovering the increases, raw material cost increases and I think I said earlier, they continue to come through with obviously with some softening in the cost of some raw materials. We expect those price increase - - the rate of increase obviously starting to fall or flatten off. But as I said, it's the value added that we're interested in, not base price on some our raw materials because we're not integrated. Anything like the extent… So again, it's quite different seeing us than other people. It's because we're not so integrated, paper is more of a pass-through for us, so it's not so critical these ups and these downs. That's why we're saying we don't the same degree of cyclicality. We're a very paper short, fibre long, packaging long business and shareholders are starting to see what that means for them in terms of profits, cash flow, and therefore dividends.

Wayne Gerry: Okay thanks. That's all I had.

Operator: *Once again, if you would like to ask a question, please press star then one on your touchtone phone.*

Ross Gilardi from Bank of America Merrill Lynch is back online with a question. Thank you.

Ross Gilardi: Yeah, hi, just had a quick follow-up. **I was just curious, what impact is this very heavy promotional environment that we're hearing about from the UK retailers having on box demand and also their willingness… Well it's not their willingness to pay for a more value-added box, it's their suppliers' willingness, but hopefully you know what I mean, if you could just comment on that.**

Miles Roberts: Yeah Ross, and it's a great, great question. Promotion activity is extremely high. It's been increasing quarter-on-quarter pretty much for the last 2.5 - 3 years. And even if you go over a five-year period, it's just becoming much more of a feature of the retail environment, and I don't think it's just about recession. I think this is about consumers being less influenced by advertising and far more influenced at the point of sale - price position, the product, the presentation, you now, the typical Ps sort of the marketing strategy - price, promotion, position, et cetera. It's becoming more important and we like that because what it means is when you go on promotion, you're never sure about the demand. It means it's got to be a more flexible supply chain, therefore your interaction with the FMCG customers supply chain is critical. And as we know, you haven't got a box to put it in, you can't supply, so it really does tie us close, and we like that. It gives us a chance to show we have the best service in the industry. I mean we are leading that in terms of on-time in-full. We survey our customers and they're telling us that. So we're seeing it promotional activity increase. I think it's going to go on for a long time to come, and that's good news for us in terms of our relationship and the value we can demonstrate to our customers.

And the second part of your question, these are world class organisations. We're talking Procter, Reckitt's, Kraft, Dannon. They are world class and they're world class in terms of procurement and if they don't think you're adding value, it's not a question of price, they're just not going to work with you. Even when they do work with you, they're going to be very demanding on value and only pay for what they think is the value you provide. And so it's tough, but it's tough for everybody. So if you're good, then you can make a return that's in line with the value that you add, and that's a position I'm very, very comfortable with. It's tough. It's difficult, but this is Europe and that's the economy and DS Smith is in a very, very good position to match their requirements, but there's a lot more for us to do. We are not where we need to be. If you look at our marketing plans, you look at how we tie innovations through to market, through to sales, sales plans linked into the customer, we are years behind where the FMCG guys are, but we're doing a lot of work there and we're going to get better. I think we're very good compared to the rest of the industry, but frankly without being too derogatory it's not a benchmark you want to use. It's our customers. They're the benchmark and that's what we're aiming towards. So at least demanding, prices are always competitive, but I'm not uncomfortable with that. It all depends on us getting better and we're getting some momentum there.

Ross Gilardi: Okay, thanks very much.

Operator: Thank you. We have no further questions at this time, gentlemen.

Miles Roberts: Well okay, I thank you very much, everybody, for dialling in this morning and listening to our Pre-Close. As I said, trading, there's positive momentum in it. It's continued with the 3% volumes coming through right up to the current time; and as well as the positive sales growth, it's been good in terms of margins and cash flow, cash flow from looking at the working capital, it's getting the pricing right, then all the efficiencies coming through as well. Otor, the business in France, just made an excellent contribution again, illustrating the sort of opportunity there is for DS Smith in this fragmented packaging market; and for this half year, we're expected to show considerable EPS growth on the comparable field last year. And looking at what we have talked through and the progress we are making towards our medium-term financial objectives, it shouldn't come as any surprise that notwithstanding the current economic environment that we remain confident in the outlook for the year. Thank you very much, everybody, again for your time.

Operator: Thank you, ladies and gentlemen. This concludes today's conference. Thank you for participating. You may now disconnect.