

RatingsDirect®

DS Smith Plc

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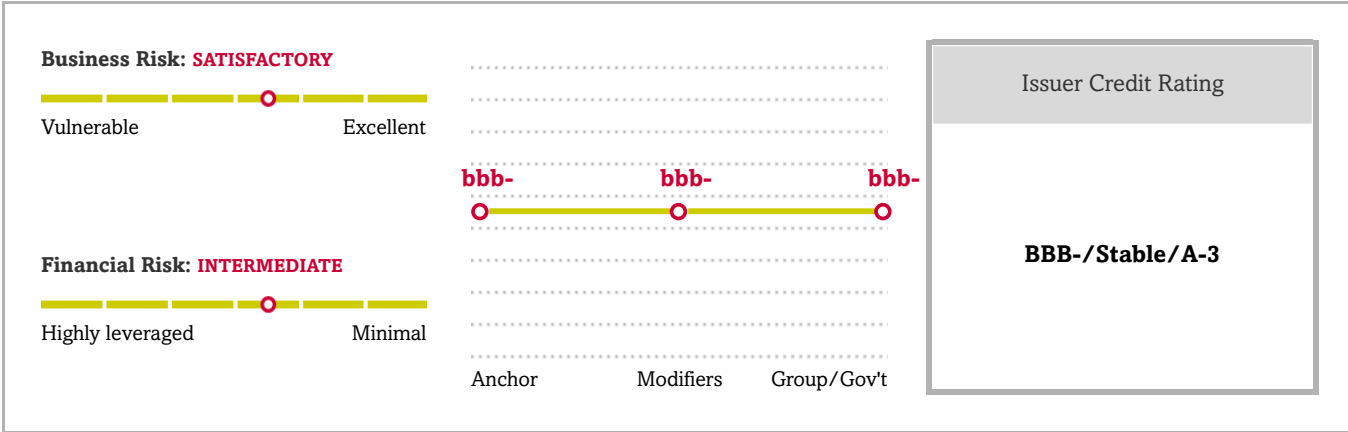
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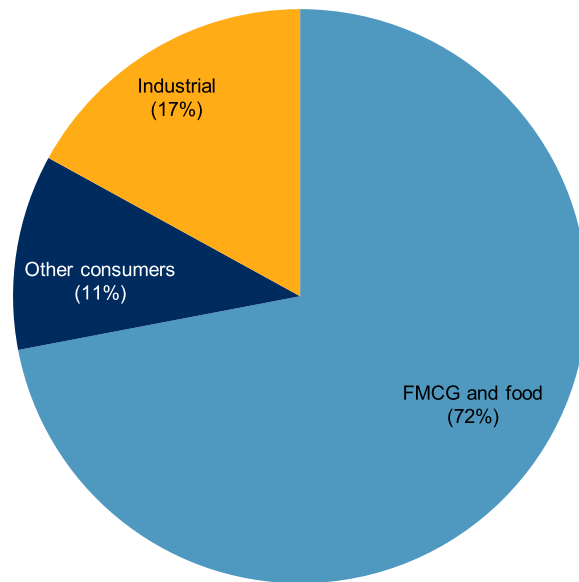


Credit Highlights

Overview

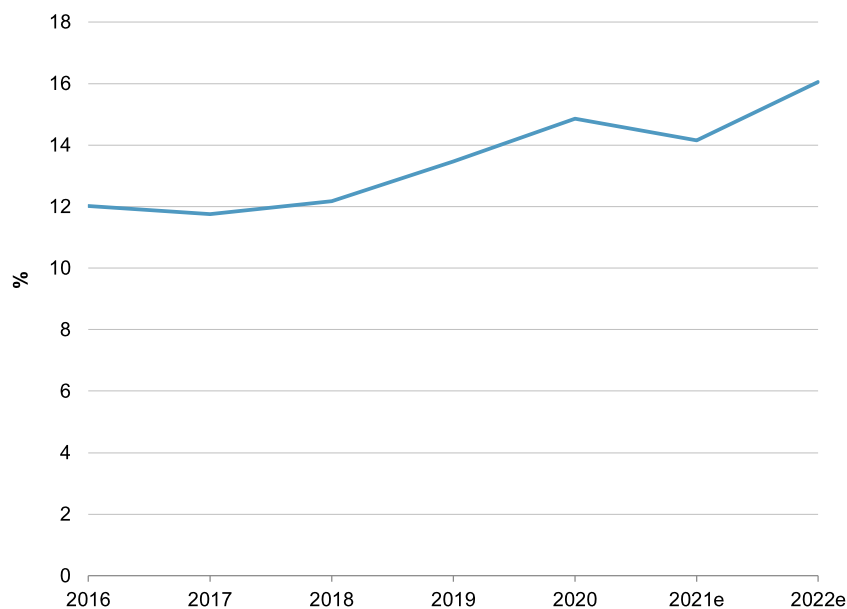
Key strengths	Key risks
Large scale and leading market position in Europe.	Commoditized product range.
Primary exposure to relatively stable end-markets.	Volatile containerboard and box prices.
Backward integration in recycling and paper production.	Exposure to volatile input prices, such as old corrugated cardboard (OCC) prices.
Adequate geographic diversification.	

S&P Global Ratings forecasts that DS Smith will record weaker profitability in its fiscal year (FY) ending April 30, 2021, than in FY2020, due to the COVID-19 pandemic. Although DS Smith has not been immune to the COVID-19 pandemic, the negative impact has been limited due to its relatively stable end-markets. Fast-moving consumer goods (FMCGs) account for about 72% of the group's packaging volumes (see chart 1). Box volumes remained flat (+0.6%) in FY2020, as lower corrugated box volumes in March and April 2020 offset the e-commerce that fueled volume growth in the first ten months of the fiscal year. These lower volumes were the result of a temporary shutdown of customer facilities during the pandemic-related lockdown.

Chart 1**DS Smith--Volumes By End Markets**
FYE April 2020

FYE--Fiscal year-end. FMCG--Fast-moving consumer goods. Source: S&P Global Ratings.
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We expect the pandemic to result in DS Smith recording a slightly weaker adjusted EBITDA margin of 14% in FY2021, down from 15% in FY2020 (see chart 2). This is due to lower box volumes, mainly in industrial packaging; higher COVID-19-related operational costs for labor and distribution; and a spike in OCC prices in April 2020. The spike in OCC prices was temporary and linked to disruptions in waste collections. We believe that the EBITDA margin will revert to 16% in FY2022 as the global economy recovers and COVID-19-related exceptional costs subside.

Chart 2**DS Smith--EBITDA Margin Trend**

e--Estimate. Source: S&P Global Ratings.

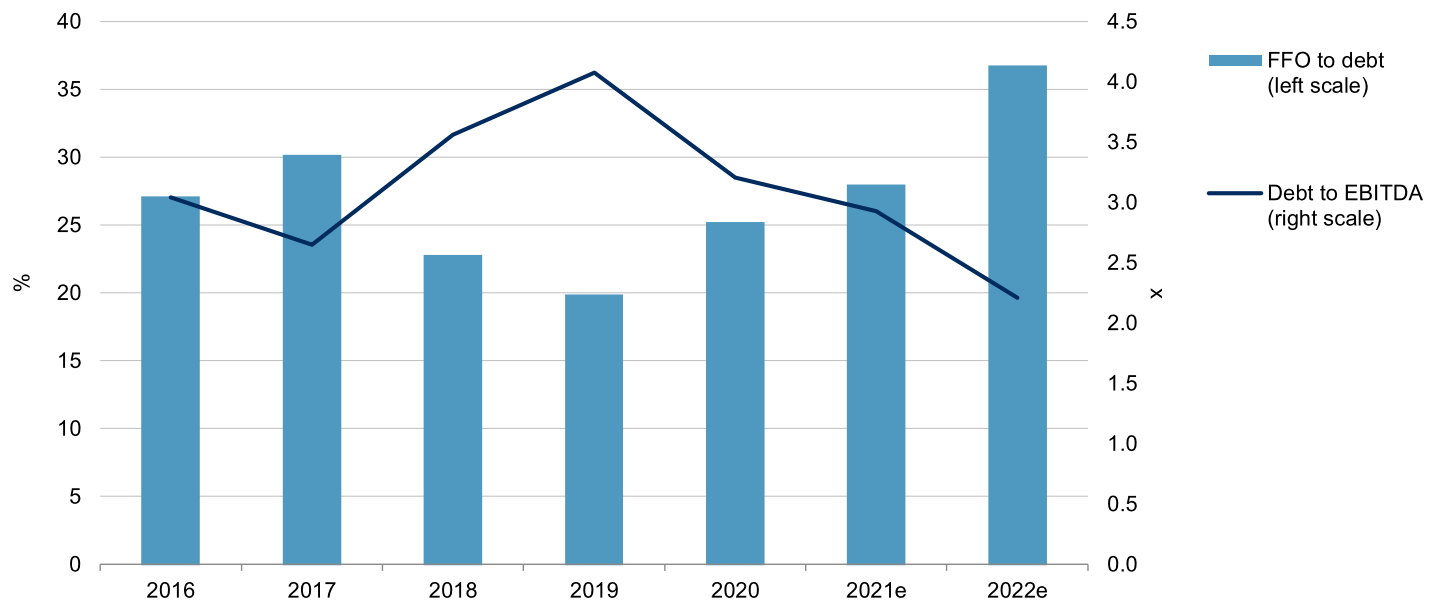
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We acknowledge a high degree of uncertainty about how quickly the global economy will recover. S&P Global Ratings acknowledges a high degree of uncertainty about the evolution of the coronavirus pandemic. The consensus among health experts is that the pandemic may now be at, or near, its peak in some regions, but will remain a threat until a vaccine or effective treatment is widely available, which may not occur until the second half of 2021. We are using this assumption in assessing the economic and credit implications associated with the pandemic (see our research here: www.spglobal.com/ratings). As the situation evolves, we will update our assumptions and estimates accordingly.

A prudent financial policy, potential divestments, and lower capital expenditure (capex) support DS Smith's credit measures. While we forecast that DS Smith's credit metrics will weaken in FY2021 as a result of the pandemic and lower selling prices, we expect the impact to be temporary, and partly mitigated by the group's prudent financial policy. As of FY2020, funds from operations (FFO) to debt stood at 25% and debt to EBITDA at 3.2x. We expect debt to EBITDA of 2.9x and FFO to debt of 28% in FY2021 (see chart 3).

Chart 3

DS Smith--Key Credit Metrics



e--Estimate. Source: S&P Global Ratings.

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We anticipate that weaker earnings will impinge on cash flow generation in FY2021. The lack of a dividend payment in FY2021 and a reduction in capital expenditure (capex) will partly offset the impact. Cash flows will also benefit from the proceeds from future asset disposals. DS Smith is likely to receive £200 million-£300 million from the disposal of paper assets in central Europe. This is in line with the group's medium-term target to be short in paper and consequently reduce its paper integration in Europe to 60% from 80% currently.

Outlook: Stable

The stable outlook reflects our view that the pandemic is likely to lead to a slight deterioration in DS Smith's credit metrics. Given the group's conservative financial policy, we expect FFO to debt to revert to about 30% and adjusted leverage to decline below 3x over the next 12 months. However, we believe that DS Smith is committed to maintaining an investment-grade rating, with cash flows supported by the deferral of the 2020 dividend, tight capex management, and the likely receipt of proceeds from asset disposals.

Downside scenario

We could lower the ratings if the negative impact from the COVID-19 pandemic is more pronounced and protracted than we anticipate. We could also consider a downgrade if DS Smith pursues a more aggressive financial policy, including higher debt-funded investments, or if it does not complete the asset disposals in a timely manner. This would most likely translate into FFO to debt remaining below 30% and debt to EBITDA exceeding 3x over a prolonged period.

Upside scenario

We view an upgrade as unlikely as DS Smith has limited headroom in its current credit measures. However, we could consider raising the ratings if FFO to debt exceeded 40% and adjusted debt to EBITDA was around 2x on a sustained basis.

Our Base-Case Scenario

Assumptions

- A decline in real GDP in the eurozone of 7.8% in 2020, before bouncing back to 2.9% growth in 2021. In the U.S., we expect a contraction in real GDP of 5% in 2020 and growth of 3% in 2021.
- A decline in revenues of 4% in FY2021 due to lower volumes in the industrial segment and reduced selling prices.
- An increase in sales of less than 3% in 2021, in line with GDP growth.
- A decline in the adjusted EBITDA margin to 14% in FY2021 from 15% in FY2020, due to lower volumes and selling prices, a temporary spike in OCC prices in April 2020, and COVID-19-related cost increases, mainly for labor and distribution. Thereafter, we expect the EBITDA margin to recover to about 16% as volumes recover and COVID-19-related costs subside.
- Annual capex of about €300 million in FY2021 and FY2022.
- Annual working capital outflows of about €10 million.
- No dividend in FY2020. Thereafter, we assume annual dividends of about £150 million-£250 million in FY2021 and FY2022.
- Disposal proceeds of about £200 million in FY2021 from the potential sale of excess paper assets in central Europe.
- About £85 million-£90 million toward the purchase of a 10% stake in Interstate Resources following the sellers'

exercise of a put option in FY2021. We assume a cash outflow of £22 million in FY2022 and £85 million in FY2023.

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

- Adjusted debt to EBITDA of 2.9x for FY2021 and 2.2x for FY2022.
- Adjusted FFO to debt of 28% for FY2021 and around 36% for FY2022.

Key metrics

DS Smith Plc--Key Metrics					
Adjusted	2019a	2020a	2021p	2022e	2023e
Revenue	6,171.0	6,043.0	5,801.3	5,975.3	6,094.8
EBITDA	831.5	898.0	821.0	958.9	966.5
Funds from operations (FFO)	671.1	725.0	672.1	777.2	784.9
Cash flow from operations (OCF)	612.1	762.0	659.1	764.2	751.9
Capex	303.0	376.0	300.0	300.0	350.0
Free operating cash flow (FOCF)	309.1	386.0	359.1	464.2	401.9
Dividends	187.0	222.0	0.0	150.0	250.0
Discretionary cash flow (DCF)	122.1	164.0	359.1	314.2	151.9
Debt	3,389.5	2,880.0	2,405.9	2,118.7	1,502.8
Cash interest expense	75.4	79.0	71.2	73.6	72.8
Interest expense	77.4	76.0	73.2	75.6	74.8
Annual revenue growth (%)	7.0	(2.1)	(4.0)	3.0	2.0
EBITDA margin (%)	13.5	14.9	14.2	16.0	15.9
Debt/EBITDA (x)	4.1	3.2	2.9	2.2	1.6
FFO/debt (%)	19.8	25.2	27.9	36.7	52.2
FFO cash interest coverage (x)	9.9	10.2	10.4	11.6	11.8
EBITDA interest coverage (x)	10.7	11.8	11.2	12.7	12.9
OCF/debt (%)	18.1	26.5	27.4	36.1	50.0
FOCF/debt (%)	9.1	13.4	14.9	21.9	26.7
DCF/debt (%)	3.6	5.7	14.9	14.8	10.1

a--Actual. p--Projected. e--Estimate. Capex--Capital expenditure.

We expect DS Smith's EBITDA margin to decline in FY2021 and recover in FY2022. We expect the EBITDA margin to decline to 14% in FY2021 because of lower volumes, lower selling prices, and COVID-19-related costs, including the temporary spike in OCC prices. We expect the EBITDA margin to recover to 16% in FY2022, as volumes of both industrial and FMCG packaging pick up, and as the COVID-19-related spike in operational and raw material costs subside.

Over the next 12-24 months, we expect DS Smith's credit metrics to improve to historical levels. We expect adjusted FFO to debt of about 30% over the next 12-24 months, compared with 25% in FY2020. We also anticipate that adjusted leverage will revert below 3x, supported by improvements in profitability and a prudent financial policy. Deferral of the FY2020 dividend, lower capex, as well as possible disposal proceeds, support cash flow.

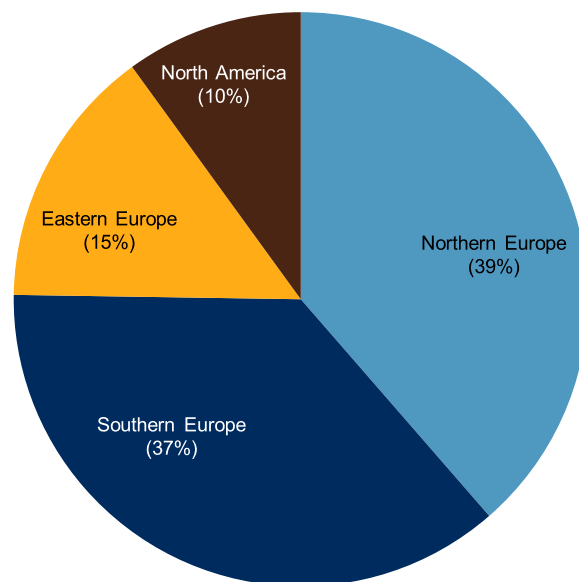
Company Description

U.K.-based DS Smith is the second-largest corrugated paper-packaging producer in a fragmented European market. It operates 14 paper mills (12 in Europe and 2 in the U.S), 200 converting plants, and around 30 recycling depots. This includes two kraftliner (virgin paper) mills, one each in the U.S. and Europe, and the remainder are for the production of testliner (recycled paper).

DS Smith relies on client proximity with its closed-loop operating model, whereby it collects and recycles cardboard boxes from retailers. In FY2020, sales exceeded £6 billion and adjusted EBITDA was £898 million. Around 14% of sales relate to the U.K., and the remainder mostly to Europe, with the U.S. accounting for around 10% of sales (see charts 4 and 5). The stable FMCG segment represents 72% of the group's FY2020 revenues.

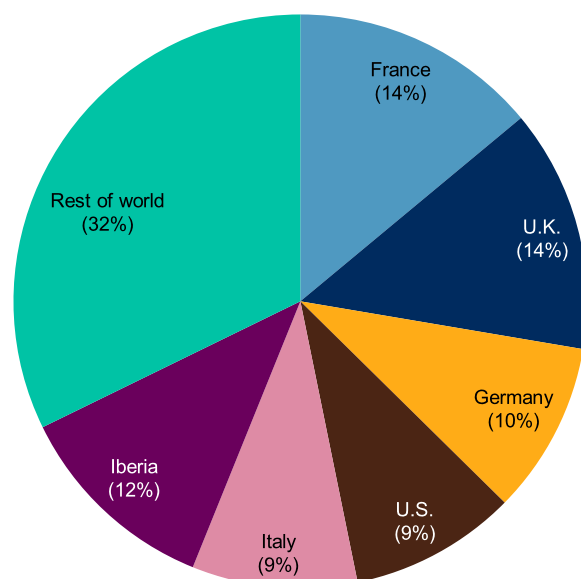
Chart 4

DS Smith--Revenue By Region FYE April 2020



FYE--Fiscal year-end. Source: S&P Global Ratings.

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Chart 5**DS Smith--Revenue By Country**
FYE April 2020

FYE--Fiscal year-end. Source: S&P Global Ratings.

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Peer Comparison

DS Smith has comprehensive pan-European coverage and a growing presence in the more consolidated and slightly more profitable U.S. market. However, the group lacks Smurfit Kappa Group PLC's or Mondi Plc's access to high-margin, low-cost, emerging markets. Instead, DS Smith focuses on higher-volume and lower-margin customers. In contrast to Smurfit Kappa, DS Smith is short in paper. This results in lower capex and EBITDA margins. That said, its return on capital is healthy. The group benefits from resilient end-markets, mainly FMCG.

Table 1

DS Smith Plc--Peer Comparison				
	DS Smith Plc	Mondi Plc	Smurfit Kappa Group PLC	International Paper Co.
Ratings as of Aug. 19, 2020	BBB-/Stable/A-3	BBB+/Stable/--	BB+/Stable/--	BBB/Stable/A-2
--Fiscal year ended--				
	April 30, 2020	Dec. 31, 2019	Dec. 31, 2019	Dec. 31, 2019
(Mil. £)				
Revenue	6,043.0	6,158.3	7,666.5	16,895.2
EBITDA	898.0	1,411.6	1,290.5	3,193.9
Funds from operations (FFO)	725.0	1,117.6	903.2	2,329.1

Table 1

DS Smith Plc--Peer Comparison (cont.)				
Interest expense	76.0	94.9	160.1	565.1
Cash interest paid	79.0	83.9	199.1	601.3
Cash flow from operations	762.0	1,098.1	963.4	2,793.4
Capital expenditure	376.0	689.7	533.8	941.6
Free operating cash flow (FOCF)	386.0	408.4	429.6	1,851.9
Discretionary cash flow (DCF)	164.0	60.2	205.0	846.9
Cash and short-term investments	592.0	62.7	160.1	385.8
Debt	2,880.0	2,008.5	3,768.9	8,593.5
Equity	3,351.0	3,715.5	2,536.0	5,827.5
Adjusted ratios				
EBITDA margin (%)	14.9	22.9	16.8	18.9
Return on capital (%)	7.3	18.9	13.0	14.8
EBITDA interest coverage (x)	11.8	14.9	8.1	5.7
FFO cash interest coverage (x)	10.2	14.3	5.5	4.9
Debt/EBITDA (x)	3.2	1.4	2.9	2.7
FFO/debt (%)	25.2	55.6	24.0	27.1
Cash flow from operations/debt (%)	26.5	54.7	25.6	32.5
FOCF/debt (%)	13.4	20.3	11.4	21.5
DCF/debt (%)	5.7	3.0	5.4	9.9

Business Risk: Satisfactory

DS Smith is the second-largest corrugated paper-packaging producer in the fragmented European market. The stable FMCG segment represented 72% of the group's revenues in FY2020. DS Smith has comprehensive pan-European coverage and a growing presence in the U.S. The U.S. containerboard and corrugated box market is more consolidated and therefore slightly more profitable than the European market.

DS Smith distinguishes itself from its peers with its focus on product innovation and value-added services. It also stands out with its vertical integration into recycling operations. This ensures the supply of recycled fiber to DS Smith's mills and box plants, but generates low margins. This and DS Smith's short paper position explain why the group's adjusted EBITDA margins are below those of other paper-packaging peers.

DS Smith pursues a short paper strategy, that is, it is a net buyer of paper. Currently, about DS Smith's 80% of operations in Europe have backward integration into paper, and the group is seeking to reduce this to 60% over the medium term. The group plans to sell some paper mills in central Europe, with completion likely over the next 12-24 months. This strategy reduces the business' capital intensity, but exposes DS Smith to unexpected shortages and price volatility in paper--mainly in testliner, and to a lesser extent in kraftliner.

Financial Risk: Intermediate

We expect DS Smith's credit measures to deteriorate as a result of the COVID-19 pandemic. As of April 30, 2020, the group's FFO to debt was 25% and its debt to EBITDA was 3.2x. We expect the credit metrics to recover in FY2021 as the global economy recovers. DS Smith's leverage is likely to improve if it successfully sells its paper mills in central Europe and uses the disposal proceeds to deleverage.

We therefore believe that the credit metrics will recover over the next 12-24 months to a level commensurate with the ratings, with FFO to debt of about 30% and adjusted leverage of less than 3x. Support also comes from DS Smith's strong commitment to maintain an investment-grade rating. In light of the challenging economic environment in 2020, DS Smith has cancelled its dividend payments for FY2021, evidencing management's commitment to maintain an investment-grade rating. DS Smith continues to review its dividend policy based on market conditions.

Financial summary

Table 2

DS Smith Plc--Financial Summary					
Industry sector: Packaging					
	--Fiscal year ended April 30--				
	2020	2019	2018	2017	2016
(Mil. £)					
Revenue	6,043.0	6,171.0	5,765.0	4,781.0	4,066.0
EBITDA	898.0	831.5	702.0	562.0	489.0
Funds from operations (FFO)	725.0	671.1	568.7	449.0	401.9
Interest expense	76.0	77.4	66.3	56.0	48.1
Cash interest paid	79.0	75.4	51.3	52.0	38.1
Cash flow from operations	762.0	612.1	46.7	537.0	363.9
Capital expenditure	376.0	303.0	347.0	244.0	229.0
Free operating cash flow (FOCF)	386.0	309.1	(300.3)	293.0	134.9
Discretionary cash flow (DCF)	164.0	122.1	(457.3)	172.0	26.9
Cash and short-term investments	592.0	379.0	294.0	139.0	134.0
Gross available cash	592.0	379.0	294.0	139.0	134.0
Debt	2,880.0	3,389.5	2,501.4	1,490.5	1,486.4
Equity	3,351.0	3,112.0	2,110.0	1,355.0	1,140.0
Adjusted ratios					
EBITDA margin (%)	14.9	13.5	12.2	11.8	12.0
Return on capital (%)	7.3	8.2	10.2	11.8	12.2
EBITDA interest coverage (x)	11.8	10.7	10.6	10.0	10.2
FFO cash interest coverage (x)	10.2	9.9	12.1	9.6	11.6
Debt/EBITDA (x)	3.2	4.1	3.6	2.7	3.0
FFO/debt (%)	25.2	19.8	22.7	30.1	27.0
Cash flow from operations/debt (%)	26.5	18.1	1.9	36.0	24.5
FOCF/debt (%)	13.4	9.1	(12.0)	19.7	9.1

Table 2

DS Smith Plc--Financial Summary (cont.)					
Industry sector: Packaging					
	--Fiscal year ended April 30--				
	2020	2019	2018	2017	2016
(Mil. £)					
DCF/debt (%)	5.7	3.6	(18.3)	11.5	1.8

Reconciliation

Table 3

DS Smith Plc--Reconciliation Of Reported Amounts With S&P Global Ratings' Adjusted Amounts (Mil. £)							
--Fiscal year ended April 30, 2020--							
DS Smith Plc reported amounts							
	Debt	Shareholders' equity	EBITDA	Operating income	Interest expense	S&P Global Ratings' adjusted EBITDA	Cash flow from operations
Reported	2,488.0	3,350.0	898.0	455.0	74.0	898.0	665.0
S&P Global Ratings' adjustments							
Cash taxes paid	--	--	--	--	--	(94.0)	--
Cash interest paid	--	--	--	--	--	(79.0)	--
Trade receivables securitizations	428.0	--	--	--	--	--	97.0
Reported lease liabilities	255.0	--	--	--	--	--	--
Postretirement benefit obligations/deferred compensation	149.0	--	3.0	3.0	2.0	--	--
Accessible cash and liquid investments	(592.0)	--	--	--	--	--	--
Share-based compensation expense	--	--	5.0	--	--	--	--
Nonoperating income (expense)	--	--	--	9.0	--	--	--
Noncontrolling interest/minority interest	--	1.0	--	--	--	--	--
Debt: Put options on minority stakes	152.0	--	--	--	--	--	--
EBITDA: Gain/(loss) on disposals of PP&E	--	--	(8.0)	(8.0)	--	--	--
Depreciation and amortization: Impairment charges/(reversals)	--	--	--	4.0	--	--	--
Total adjustments	392.0	1.0	--	8.0	2.0	(173.0)	97.0
S&P Global Ratings' adjusted amounts							
	Debt	Equity	EBITDA	EBIT	Interest expense	Funds from operations	Cash flow from operations
Adjusted	2,880.0	3,351.0	898.0	463.0	76.0	725.0	762.0

Liquidity: Strong

The short-term rating on DS Smith is 'A-3'. We assess DS Smith's liquidity as strong. We expect the group's liquidity sources to exceed its uses by more than 1.5x over the next 24 months, supported by strong cash balances and significant availability under its committed revolving credit facilities (RCFs).

Principal Liquidity Sources	Principal Liquidity Uses
<ul style="list-style-type: none"> • A cash balance of £595 million as April 30, 2020; • £1.5 billion of availability under the committed RCFs; and • Our forecast of unadjusted FFO of £670 million-£680 million. 	<ul style="list-style-type: none"> • Up to £10 million in working capital outflows; • Annual capex of around £300 million; • Debt amortization of £50 million; and • About £85 million-£90 million toward the purchase of a stake in Interstate Resources.

Covenant Analysis

The RCFs' documentation includes a leverage covenant that caps net debt to EBITDA at 3.75x. We expect that DS Smith will have ample headroom under this covenant in the near term.

Issue Ratings - Subordination Risk Analysis

We have not identified any factors that could lead to the material subordination of the senior unsecured debtholders at DS Smith.

Capital structure

The €2.6 billion of debt primarily comprises bank loans, overdrafts, and bonds.

Analytical conclusions

We rate DS Smith's unsecured obligations 'BBB-', in line with the long-term issuer credit rating, because no significant elements of subordination risk are present in the capital structure.

Ratings Score Snapshot

Issuer Credit Rating

BBB-/Stable/A-3

Business risk: Satisfactory

- **Country risk:** Low
- **Industry risk:** Intermediate

- **Competitive position:** Satisfactory

Financial risk: Intermediate

- **Cash flow/leverage:** Intermediate

Anchor: bbb-

Modifiers

- **Diversification/portfolio effect:** Neutral (no impact)
- **Capital structure:** Neutral (no impact)
- **Financial policy:** Neutral (no impact)
- **Liquidity:** Strong (no impact)
- **Management and governance:** Satisfactory (no impact)
- **Comparable rating analysis:** Neutral (no impact)

Related Criteria

- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | Industrials: Key Credit Factors For The Containers And Packaging Industry, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Business And Financial Risk Matrix

Business Risk Profile	Financial Risk Profile					
	Minimal	Modest	Intermediate	Significant	Aggressive	Highly leveraged
Excellent	aaa/aa+	aa	a+/a	a-	bbb	bbb-/bb+
Strong	aa/aa-	a+/a	a-/bbb+	bbb	bb+	bb
Satisfactory	a/a-	bbb+	bbb/bbb-	bbb-/bb+	bb	b+
Fair	bbb/bbb-	bbb-	bb+	bb	bb-	b
Weak	bb+	bb+	bb	bb-	b+	b/b-
Vulnerable	bb-	bb-	bb-/b+	b+	b	b-

Ratings Detail (As Of August 19, 2020)*

DS Smith Plc

Issuer Credit Rating BBB-/Stable/A-3

Senior Unsecured BBB-

Issuer Credit Ratings History

13-Jun-2019 BBB-/Stable/A-3

18-Jun-2018 BBB-/Negative/A-3

10-Mar-2015 BBB-/Stable/A-3

*Unless otherwise noted, all ratings in this report are global scale ratings. S&P Global Ratings' credit ratings on the global scale are comparable across countries. S&P Global Ratings' credit ratings on a national scale are relative to obligors or obligations within that specific country. Issue and debt ratings could include debt guaranteed by another entity, and rated debt that an entity guarantees.

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