

Research Update:

# U.K.-Based Packaging Producer DS Smith Outlook Revised To Stable On Lower Leverage; 'BBB-' Rating Affirmed

June 13, 2019

## Rating Action Overview

- Packaging producer DS Smith PLC has reduced its leverage following agreed asset disposals and EBITDA growth, supported by the expected benefits of recent acquisitions, including of Europac. Its debt to EBITDA ratio is in line with the rating.
- We are therefore revising our outlook on DS Smith to stable from negative.
- We are affirming our 'BBB-' long-term and 'A-3' short-term issuer credit ratings and on the company. We are also affirming our issue ratings on its senior unsecured debt.
- The stable outlook reflects our expectation that credit metrics will remain commensurate with the current rating over the next 12-24 months.

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## Rating Action Rationale

The outlook revision follows the publication of DS Smith's results for the financial year ended April 30, 2019 (FY2019). It is also supported by the two asset disposals, which we expect to close in 2019. The sale of the plastic division is expected to net proceeds of £400 million, and the sale of two corrugated box plants is expected to net €65 million (around £54 million). Thereafter, we expect credit metrics to remain in line with the current rating category.

Our 'BBB-' long-term issuer credit rating is supported by the strong underlying cash generation of DS Smith's operations, management's strong track record of successfully integrating acquisitions, and a financial policy that enabled DS Smith to bring credit metrics back in line with the current rating level.

We continue to assess DS Smith's business risk profile as satisfactory on the back of its strong market shares, economies of scale, and proximity to customers.

## Outlook

The stable outlook reflects our view that DS Smith's credit metrics will remain in line with the current rating. We believe that the group will continue to focus on integrating its recent acquisitions and generate substantial positive free operating cash flow (FOCF) over the next two years.

## Downside scenario

We could consider a downgrade if DS Smith embarked on significant debt-funded shareholder distributions or larger acquisitions than we expect, without suitable mitigants. We could also 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 funds from operations (FFO) to debt below 30% on a sustained basis.

## Upside scenario

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

## Company Description

DS Smith is the second-largest corrugated paper packaging producer in the fragmented European market. It operates 16 paper mills, over 200 converting plants, and around 30 recycling depots. Sales in FY2019 amounted to over £6.1 billion and S&P Global Ratings-adjusted EBITDA was £829 million.

Around 15% of sales relate to the U.K., and the remainder mostly to Europe, with the U.S. accounting for around 10% of sales. The stable fast-moving consumer goods (FMCG) segment represents the majority of the group's revenues.

DS Smith distinguishes itself from its peers via its focus on product innovation and value-added services. It also has a long position in recycling and is the largest paper recycler in Europe, collecting about 5 million tons annually. We assess the group's business risk profile as satisfactory.

DS Smith has comprehensive pan-European coverage and a growing presence in the more consolidated and slightly more profitable U.S. market. However, the company lacks Smurfit Kappa Group's or Mondi's access to high-margin, low-cost emerging markets. Instead, DS Smith focuses on higher-volume and lower-margin customers.

DS Smith relies on client proximity with its closed-loop operating model, whereby it collects and recycles cardboard boxes from retailers.

In contrast to Smurfit Kappa, DS Smith is short in paper. It sources around 400,000 tons of testliner and around 150,000 tons of kraftliner externally. This results in lower capital expenditure (capex) requirements, but also slightly lower adjusted EBITDA margins. That said, its return on capital is healthy. The group's relatively low absolute profitability is partly offset by the resilience

of its FMCG packaging end-markets, translating into what we view as fair volatility of profitability through the economic cycle.

## **Our Base-Case Scenario**

Our base-case scenario assumes:

- Revenue growth of around 11.6% in FY2020, primarily from the full year contribution of the Europac acquisitions. We also expect a slight decline in corrugated packaging prices.
- A slight improvement in EBITDA margins as DS Smith integrates Europac, continues with efficiency measures, and moves toward higher-margin products, with a lower share of paper and recycling sales.
- Annual capex of around £370 million.
- Annual dividends of around £210 million-£230 million.
- No material acquisitions.

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

- Adjusted debt to EBITDA of 2.4x for FY2020 and 2.1x for FY2021.
- Adjusted FFO to debt of 33% for FY2020 and around 38% for FY2021.

## **Liquidity**

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 healthy cash balances and significant availabilities under its committed revolving credit facilities. In addition, any issuance under DS Smith's euro medium-term note program would further extend the group's debt maturity profile and support our liquidity assessment.

Principal liquidity sources are:

- Our assumption of £382 million of cash on balance sheet that we consider as unrestricted as of April 30, 2019;
- Our assumption of £1.1 billion available under the £1.5 billion committed revolving credit facilities; and
- Our forecast unadjusted FFO of £800 million-£810 million.

Principal liquidity uses are:

- Up to £10 million in working capital outflows in FY20;
- Annual capex of around £370 million;
- Debt amortization of £200 million-£250 million; and
- Annual dividends of around £210 million-£230 million.

## Covenants

DS Smith has covenants on its RCF, the tightest of which is reported debt to EBITDA of less than 3.25x. We expect the group to meet this covenant with adequate headroom.

## Environmental, Social, And Governance

DS Smith's credit profile benefits from its vertical integration into cardboard and paper recycling, which it uses in its paper making processes. The company's corrugated packaging materials are fully recyclable. DS Smith also seeks to reduce its waste to landfill; but waste import restrictions in China have made this more challenging.

DS Smith also sources all of its pulp for kraft mills from certified sustainable sources, including its own forest assets (18,000 hectares in Georgia). The group also seeks to lower its water and energy consumption as well as carbon emissions.

DS Smith seeks to maintain a productive and safe workplace by minimizing the risk of accidents, injury, and exposure to health hazards. A large portion of DS Smith's capex on Europac related to health and safety measures.

We view DS Smith's management and governance as satisfactory, reflecting in part management's track record of successfully identifying and integrating acquisitions, executing its cost-saving and revenue diversification strategy, and the independence of its board.

## Issue Ratings - Subordination Risk Analysis

We have not identified any factors leading to material subordination of the senior unsecured debtholders at DS Smith PLC.

## Capital structure

As of April 30, 2019, DS Smith PLC's capital structure comprised around £2.7 billion in unsecured debt issued by DS Smith PLC, which is subordinated to around £176 million debt issued by Europac.

## Analytical conclusions

The unsecured €500 million 2.25% notes due 2022 issued by DS Smith PLC, as well as the notes (€750 million due 2024 and £250 million notes due 2029) issued by DS Smith PLC under the medium-term note program, are rated 'BBB-', the same as the issuer credit rating, as no sources of significant subordination have been identified.

## 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**

- 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
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- Criteria - Corporates - Industrials: Key Credit Factors For The Containers And Packaging Industry, 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 And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

## **Ratings List**

**Ratings Affirmed; Outlook Action**

	To	From
<b>DS Smith Plc</b>		
Issuer Credit Rating	BBB-/Stable/A-3	BBB-/Negative/A-3
Senior Unsecured	BBB-	BBB-

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.capitaliq.com](http://www.capitaliq.com). All ratings affected by this rating action can be found on S&P Global Ratings' public website at [www.standardandpoors.com](http://www.standardandpoors.com). Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings 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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