3 March 2021

DS Smith Q3 Trading Update

Participants

Miles Roberts – Speaker

Adrian Marsh – Speaker

Operator: Hello and welcome to the DS Smith Q3 Trading Update. My name is Rosie and I'll be your coordinator for today's event. Please note, this call is being recorded. And, for the duration, your lines will be on listen only. However, you will have the opportunity to ask questions. This can be done by pressing star one on your telephone keypad to register your question at any time. If you require assistance, please press star zero and you'll be connected to an operator. I will now hand you over to Miles Roberts to begin today's conference. Thank you.

Miles Roberts: Well, good morning everybody. And thank you for joining us today. I'm Miles Roberts, the CEO of DS Smith, and I'm joined by Adrian Marsh, our finance director. I should say our statement today covers the trading period since the 1st of November, 2020. First of all, obviously we all hope everybody on the call is safe and well. And throughout these really very strange times, I continue to be immensely grateful to everybody who works in DS Smith for their commitment that has allowed every one of our plants to remain open and fully operational. They, together with our scale, footprint and our leading position in recycling and packaging, have enabled us to deliver for our customers throughout the entire period of this pandemic.

And trading continues to progress well. The trends described in our half one results in December have continued into H2. We are seeing particularly strong box volume growth driven by differentiated offering. And whilst input costs have increased, overall trading remains fully in line with our expectations. Like for like box volume growth has accelerated compared to Q2 of this financial year. And the expected e-commerce and FMCG strength over Christmas has indeed continued into 2021 together with some early, but very encouraging, signs of recovery in the industrial sector. Very pleasingly, our North American business continues to deliver strongly improving results as a consequence of good domestic growth with corresponding reduced exports of paper, but also with increased pricing.

Input costs, including OCC, have increased in the period, which, together with high demand, continues to drive paper prices higher. We've already started to recover these additional costs through higher packaging prices. And our expectation is, with a customer lag, that we fully expect to recover in these increases, which, again, will really underpin our momentum into 2022. Working capital and cash generation remain key areas of focus. And we anticipate a continued strong free cash flow performance in the year with cash conversion of over 100%. But as you will know, we're the leader in sustainability, and we operate a circular business where we collect more packaging, we recycle more packaging than we produced. And we are purely focused on a fibre-based products supporting and benefit from the plastic replacement trends.

And I'm also delighted, more widely, we've been upgraded by a number of ESG rating agencies in the period. But carbon reduction, our carbon reduction program is progressing very well. And we expect to achieve another year of excellent progress. It is not enough to only be low carbon, it is also the product that you make. That is why we are purely faced on fibre-based packaging, working with our customers to replace plastics at every opportunity and that doesn't conflict with other parts of our business. So, in summary, we're seeing excellent demand from FMCG and e-commerce customers. And we continue to invest for growth in these areas, such as our new plants that we announced in December. COVID-19 continues to accelerate a number of the structural growth drivers and our leading positions in recycling and fibre-based packaging, together with our growing, really very exciting, digital platforms position us well to capitalize on this in the future and drive further market share gains.

Whilst the economic environment remains uncertain, we're experiencing good momentum across the business. And we're confident of delivering results in line with our expectations for the year, and showing further good progress and momentum as we move into the next financial year. Thank you very much. And now I'll open with Adrian to answer any questions people may have.

Operator: As a reminder, if you would like to ask a question, please press star one on your telephone keypad. Should you wish to withdraw your question, you can press star two. You will be advised when to go ahead. So, again, it's star one on your telephone keypad. And our first question comes from the line of Sam Bland from JP Morgan. Please go ahead.

Sam: Morning. I have two questions, if I can, please. The first one is - e-commerce is helping to drive pretty strong volumes at the moment. Any thoughts on that, or what you're hearing from customers around how permanent and sticky that e-commerce volume could prove to be as obviously shops reopen at some point in the future? And the second question is on exceptional items, cash exceptionals. Just any comments on - I think there's about 50 million expected in the current year where that could go to - in the year to April 22 as the integration comes to a close. Thank you.

Miles Roberts: Thank you, Sam. I'll take the first question and then Adrian will comment on the second. E-commerce has been has very strong overall in the volumes. I think what's very interesting though, throughout the pandemic we really saw some of the really big e-tailers really accelerating their position. And that has and remains very strong. But during this pandemic we've seen a number of other customers who haven't had their own platform starting to develop their own e-commerce platform. So, that in the future, if the high street doesn't have the footfall that it's had in the past, they will be able to have their own offering going direct to the consumer.

Now, this is a really interesting area for us, because the packaging is not just about a delivery and keeping the product safe, it's also about a different relationship - enhancing the relationship between the supplier, the producer, and the final consumer. So, in this area, we're seeing good growth. But the quality and the type of packaging is developing really very rapidly. More personalization, more product presentation within the box. And I think this is the trend we're very pleased to see coming through. And when we look forward, even though the shops will reopen, I think these platforms that people have built will continue to be a major focus for them, because maybe who knows what'll happen next winter. I think having a strong e-commerce platform is going to be strong for them. What's also interesting is the way that customers want to transact with us. They want to communicate, they want to develop and design.

That has changed as well. And, as you know, we've built some fantastic digital platforms. We talked about some of them at the half year. With things like E-pack where anybody can go online and order packaging. The response to these has been absolutely electrifying. It really has. We're rolling them out across Europe. But the other digital platforms we've created, how people can continue to design and create their packaging even when we're not meeting physically together, that's been a very strong trend with us. So, it's been a very interesting time, but I think there's an awful lot of mileage still left in the whole e-commerce development area.

Adrian Marsh: Just on the second question, Sam, obviously I'll give proper guidance at the usual time when we announce our full year results. However, you're absolutely right. The integration of recent M&A concludes this year. So, absent anything that I don't know as of today, you can assume there'll be a significant reduction in cash exceptionals next year.

Operator: Our next question comes from the line of Cole Hathorn from Jefferies. Please go ahead.

Cole Hathorn: Morning Miles. Morning Adrian. Encouraging 3Q trading update. But looking out into FY22, I hope you can just help us understand the driving blocks of what should be a, hopefully, positive growth and profit year for FY22. What's going to be the drivers? Is it higher box volumes? Pricing? North America recovery? What builds that bridge to over 600 million EBITDA level?

Miles Roberts: It's a very good question, because we're finalizing budgets. You're absolutely right. It's about the volume going forward. And, again, we've got our segmentation in particular product groups, types of packaging, customers and regions. We've done fantastically well with some - with our large customers. We work for all the largest FMCG companies right across Europe. Our service, and quality, and innovation has been excellent, and we're seeing continued very strong momentum there. It's been very good. They've been very appreciative of our service and quality throughout the whole period. But these digital platforms we're creating is also giving us some very encouraging opportunities with smaller customers.

What are we are seeing in terms of sectors? I think FMCG is going to remain strong, particularly with the e-comm business. We are seeing a slight return on industrial, and we do expect that to continue. So, we see a good volume trajectory into the coming year. In terms of pricing, we've seen some significant increases in the price of paper. Interesting, paper still isn't back to the price it was just over two years ago. We're very well experienced in how to recover this. We're already out and I have to say, the progress we've made to date has actually been very encouraging. It's been very strong demand at the same time. But, as I said, the fundamentals, the service and quality and innovation - they want. So, I think we'll be getting these increases back with our customary lag. It takes us between three and four months on average.

And sitting here at the end of February, looking at the increases that came in towards the end of last year, we are fully consistent with that on pricing. You're right. We've got North America, that's coming back strongly. Very pleased to see that. You've seen the profits that we've made in that division previously. We know the reason the profits fell, because the paper was exported. So, we're now building the volumes in North America, domestic packaging volumes. The new plant that has opened, that's coming along very nicely. And that has quite a significant effect. And then, of course, we've got our new investments that we've spoken about. We have continued to invest in new capacity and new sustainable solutions to replace plastics. We've got the two new sites, should be on stream towards the end of our next financial year.

To be honest, we can't wait for them to come online. We're feeling there's a very strong pipeline of opportunity there, both in Italy and in Poland. Yeah, they'll be online at the end of next year.

Adrian Marsh: You've also got COVID, don't forget. We took a reasonably significant hit in our first half for COVID specific costs that we said we'd gradually process, re-engineer away. That is happening. We're operating much more efficiently as every month goes through. And we'll have the benefits of other capital that we've invested, efficiencies carrying on, as we always do, as you know. We always focus hard on efficiency programs, but we won't be repeating the one-off costs that we had for COVID in the first half, assuming that the world recovers as we expect.

Carl Hawthorne: No, thank you. Thank you very much.

Operator: Our next question comes from the line of Mikael Doepel from UBS. Please go ahead.

Mikael: Yes. Hi. Good morning. Just a quick question here. I was wondering about the industrial end use. You're mentioning that part of the business showing some signs of recovery. So, it's basically two questions there. One, how big is that exposure to you? And secondly, where, in particular, do you see this recovery there? Thanks.

Miles Roberts: The industrial sector is about - typically over the previous year was about 16%, 17% of our business. And we saw that at the start of the pandemic, because a lot of our customers in those sectors weren't essential businesses, they effectively closed. We have seen a recovery. And instead of being down circa 10%, pretty much in line with the economies last year, we expect that to return to growth. All the signs are that that is happening. Customers are obviously dusting down their plans, now a lot of them have restarted production. And there's some encouraging signs coming out of them. It's still early days, but there's some quite encouraging signs. Clearly governments' looking to boost economies with investment.

We can see all the green funds, substantial funds, obviously looking to boost economies, plus national governments as well. Infrastructure spend, et cetera, is being talked about. And the industrial sector is responding. So, we do expect it to be back in growth. That does make a difference - it does make a quite a difference to us. And the second question was?

Adrian Marsh: I think it was in the industrial. Our focus, obviously, we were trying to continue to grow our exposure to FMCG, the two new greenfields are very much around FMCG growth. So, I think, again, over time we're - that exposure to the more cyclical industrial sector will decline.

Mikael: Thank you.

Operator: The next question comes from the line of David O'Brien from Goodbody. Please go ahead.

David O'Brien: Morning guys. Thanks for taking my questions. Firstly, just on OCC. If we mark to market here, what is the headwind for FY21 as we stand? Secondly, it's encouraging to hear that box prices look to be turning already, can you just give us a sense of the feedback from customers on the ground as you implement increases across your business? It looks like even though there are paper price increase out in the markets, any feedback you can give on that as well?

Miles Roberts: Thank you, David. OCC you can see the headline numbers - there's quite a bit of volatility there. And the volatility is coming from, obviously, high demand, but also the availability. A lot of this OCC seems to be in people's garages rather than in the normal high street stores. And then, of course, we've had some poor weather as well, which has just restricted some of the supply. So, it's come down from about probably about eight or nine days stock, it's currently around about seven days. Mostly people are starting to think about the Easter shut. So, at the moment, we have seen, if we look at deliveries into March, the cost has gone up quite a bit from February. But think there's just a number of very unusual factors there. The recent spike, I think, will come off.

But the prices are higher. If we look in the final quarter, let me see, it's difficult to know because the volatility, but it could be circa 20 a ton, something like that, on the price of OCC, on average, final quarter compared to the previous quarter.

Adrian Marsh: Agreed. I think it's harder to mark to market simply because it's now going through into paper prices, which is your last question, David. And paper prices are going through to packaging. So, we called out, at our full year results, an impact of the spike when the OCC rose significantly. But that wasn't accompanied at the time with a rise in the price of paper. And, therefore, it caught us particularly hard. But, yeah, going into Q4, we've got that headwind as that flows through to paper price rises which flow into packaging, which are then recovered as Miles described in - with our usual lags. So, there's a little bit of left pocket, right pocket between Q4 this year and Q1 next year. You're absolutely right.

Miles Roberts: And, on the pricing - we have been out already recovering the increases that that came through in October, November. And, look, nobody likes a price increase, but demand is very strong and people want the quality, and they want the service. And it did come off - it does come on the back of actually some reductions. So, nobody likes the increase, but they are going through. And they are being accepted. I have to say, just generally, I know there's different reports, but I wouldn't be surprised if they was generally just a bit more inflation coming through. We've definitely strengthened our position during the pandemic, our market shares, et cetera, I've talked about service and quality. So, those price increases are going through.

And on the testliner price increase, first question on the OCC, then testliner prices, they're not small. It's not 10 and 20, these are fifties going through. And that really does mirror the strength of demand. And those price increases are going through. So, in fact, we saw another one yesterday. And we weren't surprised by that at all, we've made various announcements. With OCC where it is, I wouldn't be surprised if there were some more as well. But it's still not back to the price it was just over two years ago. So, we feel pretty confident that this will be accepted by the by the market. And that's in Europe and the US as well.

Adrian Marsh: Yeah. If we look back on that scenario three years ago, when prices rose materially, we saw the whole market recovering it, because it has to do, because there's no other option. So, in certain respects, it's a lot more sensitive to large price rises than it is to small price rises on input costs.

David O'Brien: Thank you.

Operator: We have no further questions coming through. So, Miles, I will hand back to you for any concluding remarks.

Miles Roberts: Firstly, thank you. Again, thank you everybody for your time. Just to say that we're pleased to see the trends that we saw in the first half really continue. Volumes are good. Pricing's going up. And we really looking forward to further progress into full year 2022. Thank you for your time.

Adrian Marsh: Thank you.

Operator: Thank you for joining today's conference. You may now disconnect your lines. Host, if you could please stay connected and await further instruction. Thank you.