

# RatingsDirect®

---

## Research Update:

### U.K.-Based Paper Packaging Producer DS Smith Affirmed At 'BBB-/A-3' On Plan To Acquire Interstate; Outlook Stable

#### Primary Credit Analyst:

Terence O Smiyan, London (44) 20-7176-6304; [terence.smiyan@spglobal.com](mailto:terence.smiyan@spglobal.com)

#### Secondary Contact:

Gustav Liedgren, Stockholm (46) 8-440-5916; [gustav.liedgren@spglobal.com](mailto:gustav.liedgren@spglobal.com)

## Table Of Contents

---

Overview

Rating Action

Rationale

Outlook

Ratings Score Snapshot

Related Criteria

Ratings List

## Research Update:

# U.K.-Based Paper Packaging Producer DS Smith Affirmed At 'BBB-/A-3' On Plan To Acquire Interstate; Outlook Stable

## Overview

- U.K.-based paper packaging producer DS Smith has entered into a binding agreement to acquire an 80% share of U.S.-based Interstate Resources (value of £722 million).
- DS Smith plans to finance the acquisition through a combination of cash proceeds from debt and equity issuance, and its own equity.
- We are affirming our 'BBB-/A-3' ratings on DS Smith, since we believe DS Smith's credit metrics will remain commensurate with the current ratings over time, despite some worsening in the short term.
- The stable outlook reflects our view that DS Smith will successfully integrate Interstate, resulting in improving profitability, and that its credit metrics will recover rapidly in fiscal year 2019.

## Rating Action

On July 3, 2017, S&P Global Ratings 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

The affirmation follows DS Smith's announcement that it has entered into a binding agreement to acquire an 80% equity stake in U.S.-based paper and packaging player Interstate Resources Inc. for a total consideration of \$1.15 billion (approximately £900 million) including its financial debt. The transaction is expected to close over the following three months.

DS Smith intends to finance the acquisition with the issuance of £386 million of new debt, a £280 million equity increase, and £236 million of the group's shares. Interstate's previous owner will retain 20% of the company's equity. But a put option, which we consider in our adjusted debt figure, exercisable within five years after the closing of the transaction, will allow DS Smith to acquire 100% of the group. Although we expect DS Smith's credit metrics will weaken slightly in fiscal year ending April 30, 2018 (fiscal 2018) as a result of the transaction, we expect that DS Smith will continue to generate strong cash flow generation that helps its credit ratios recover quickly in subsequent years. We expect the group will maintain its prudent financial

policy, as demonstrated by the significant proportion of equity in the transaction, and focus on deleveraging. We therefore do not anticipate any further material debt-funded acquisitions or higher-than-usual shareholder distributions in the short term.

We view the acquisition as moderately positive from a business risk perspective, since Interstate provides DS Smith a route into the attractive U.S. market, allowing the group to increase its organic growth prospects, improve group EBITDA margins, and realize synergies and opportunities to further improve efficiency through working capital management and cost rationalization. Nevertheless, we consider that following a successful integration of Interstate, DS Smith would remain somewhat weaker than peers like Smurfit Kappa or Mondi, primarily due to lower profitability but also weaker geographic diversification and smaller scale.

In our base case for DS Smith, we assume:

- Underlying organic revenue growth (excluding foreign-exchange effects and acquisitions) of high single digits in fiscal 2018, reflecting our expectations of positive volume growth and materially increased prices. For the subsequent periods, we forecast organic revenue growth of 2%-3% per year.
- Acquisition spending will be limited in fiscal 2018, since we expect DS Smith will focus on the integration of Interstate. Thereafter, we forecast a gradual increase in acquisitions to historical levels of up to \$200 million per year.
- Slightly improving EBITDA margins in fiscal 2018 to 11%-12% (after exceptional costs). For 2019 and 2020, we expect EBITDA margins will show further improvement toward the 13%-14% range.
- Annual capital expenditure (capex) slightly increasing to around 5% of sales (or £250 million) in fiscal 2018 and stabilizing at 4%-5% of sales in subsequent years.

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

- Funds from operations (FFO) to debt of about 27% in fiscal 2018 (about 29% on a pro forma basis), recovering to above 30% thereafter.
- Debt to EBITDA increasing to 2.7x in fiscal 2018 (2.6x on a pro forma basis) from 2.3x in fiscal 2017, rapidly improving thereafter toward 2.0x-2.5x.

## **Liquidity**

The strong liquidity assessment is supported by our expectation that the company's liquidity sources will exceed its liquidity uses by 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:

- £139 million of unrestricted cash as of April 30, 2017;
- Access to a largely undrawn committed RCF of £800 million;

- Our forecast of cash FFO of about £450 million-£500 million;
- Working capital inflows of about £15 million; and
- £280 million from new equity and £400 million of new debt facilities to finance the acquisition of Interstate.

These sources compare with the following liquidity uses for the same period:

- Seasonal working capital requirements of about £60 million;
- Expected dividend distributions of £120 million-£140 million;
- Capex of about £300 million; and
- The acquisition of 80% of Interstate's equity and all of its existing debt for a cash consideration of around £666 million.

## Outlook

The stable outlook reflects our view that DS Smith will successfully integrate Interstate, increasing its organic revenue growth and improving the group's profitability, while generating substantial positive free operating cash flow over the next two years. Although we expect the group's leverage will increase in the short term, we believe that management will maintain prudent financial policy and credit metrics will rapidly recover over the subsequent periods, with FFO to debt stabilizing at 30%-40%.

### Downside scenario

We could consider a downgrade if DS Smith embarked on further large debt-funded shareholder distributions or acquisitions, without suitable mitigants. We could also consider a negative rating action if DS Smith failed to show signs of successful integration of the acquired Interstate, experienced severe margin pressure, or generated weaker cash flows than we anticipate, leading to prolonged weaker credit metrics--for example, debt to EBITDA of more than 3x, and FFO to debt below 30%--for more than 12 months.

### Upside scenario

We consider ratings upside to be limited in the short term, due to the expected deterioration in credit metrics for fiscal 2018 as a result of the acquisition of Interstate. However, we could consider raising the ratings if we believed that DS Smith could sustain adjusted debt to EBITDA of about 2x and FFO to debt exceeding 40%, with a publicly communicated financial policy that supported maintenance of such metrics.

## Ratings Score Snapshot

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

Business risk: Satisfactory

- Country risk: Intermediate
- 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)
- Liquidity: Strong (no impact)
- Financial policy: Neutral (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

## Related Criteria

- 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: Ratios And Adjustments, 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: Group Rating Methodology, 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
- Criteria - Corporates - General: 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

## Ratings List

Ratings Affirmed

DS Smith Plc

Corporate Credit Rating

Senior Unsecured

BBB-/Stable/A-3

BBB-

### Additional Contact:

Industrial Ratings Europe; Corporate\_Admin\_London@spglobal.com

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 the 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.

Copyright © 2017 by Standard & Poor's Financial Services LLC. All rights reserved.

No content (including ratings, credit-related analyses and data, valuations, model, software or other application or output therefrom) or any part thereof (Content) may be modified, reverse engineered, reproduced or distributed in any form by any means, or stored in a database or retrieval system, without the prior written permission of Standard & Poor's Financial Services LLC or its affiliates (collectively, S&P). The Content shall not be used for any unlawful or unauthorized purposes. S&P and any third-party providers, as well as their directors, officers, shareholders, employees or agents (collectively S&P Parties) do not guarantee the accuracy, completeness, timeliness or availability of the Content. S&P Parties are not responsible for any errors or omissions (negligent or otherwise), regardless of the cause, for the results obtained from the use of the Content, or for the security or maintenance of any data input by the user. The Content is provided on an "as is" basis. S&P PARTIES DISCLAIM ANY AND ALL EXPRESS OR IMPLIED WARRANTIES, INCLUDING, BUT NOT LIMITED TO, ANY WARRANTIES OF MERCHANTABILITY OR FITNESS FOR A PARTICULAR PURPOSE OR USE, FREEDOM FROM BUGS, SOFTWARE ERRORS OR DEFECTS, THAT THE CONTENT'S FUNCTIONING WILL BE UNINTERRUPTED, OR THAT THE CONTENT WILL OPERATE WITH ANY SOFTWARE OR HARDWARE CONFIGURATION. In no event shall S&P Parties be liable to any party for any direct, indirect, incidental, exemplary, compensatory, punitive, special or consequential damages, costs, expenses, legal fees, or losses (including, without limitation, lost income or lost profits and opportunity costs or losses caused by negligence) in connection with any use of the Content even if advised of the possibility of such damages.

Credit-related and other analyses, including ratings, and statements in the Content are statements of opinion as of the date they are expressed and not statements of fact. S&P's opinions, analyses, and rating acknowledgment decisions (described below) are not recommendations to purchase, hold, or sell any securities or to make any investment decisions, and do not address the suitability of any security. S&P assumes no obligation to update the Content following publication in any form or format. The Content should not be relied on and is not a substitute for the skill, judgment and experience of the user, its management, employees, advisors and/or clients when making investment and other business decisions. S&P does not act as a fiduciary or an investment advisor except where registered as such. While S&P has obtained information from sources it believes to be reliable, S&P does not perform an audit and undertakes no duty of due diligence or independent verification of any information it receives.

To the extent that regulatory authorities allow a rating agency to acknowledge in one jurisdiction a rating issued in another jurisdiction for certain regulatory purposes, S&P reserves the right to assign, withdraw, or suspend such acknowledgment at any time and in its sole discretion. S&P Parties disclaim any duty whatsoever arising out of the assignment, withdrawal, or suspension of an acknowledgment as well as any liability for any damage alleged to have been suffered on account thereof.

S&P keeps certain activities of its business units separate from each other in order to preserve the independence and objectivity of their respective activities. As a result, certain business units of S&P may have information that is not available to other S&P business units. S&P has established policies and procedures to maintain the confidentiality of certain nonpublic information received in connection with each analytical process.

S&P may receive compensation for its ratings and certain analyses, normally from issuers or underwriters of securities or from obligors. S&P reserves the right to disseminate its opinions and analyses. S&P's public ratings and analyses are made available on its Web sites, [www.standardandpoors.com](http://www.standardandpoors.com) (free of charge), and [www.ratingsdirect.com](http://www.ratingsdirect.com) and [www.globalcreditportal.com](http://www.globalcreditportal.com) (subscription) and [www.spcapitaliq.com](http://www.spcapitaliq.com) (subscription) and may be distributed through other means, including via S&P publications and third-party redistributors. Additional information about our ratings fees is available at [www.standardandpoors.com/usratingsfees](http://www.standardandpoors.com/usratingsfees).

STANDARD & POOR'S, S&P and RATINGSDIRECT are registered trademarks of Standard & Poor's Financial Services LLC.