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## Research Update:

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


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## 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 | BBB-/Stable/A-3 |
| Senior Unsecured | BBB- |

**Additional Contact:**
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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 for further information. Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on the S&P Global Ratings' public website at 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.