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DS Smith Pre-Close Statement
Conference Call Transcript

Speaker key

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AM	Adrian Marsh
BD	Barry Dixon
CO'G	Catriona O'Grady
DO'B	David O'Brien
JJ	Justin Jordan
AM	Alexander Mees
HF	Hector Forsythe

MR Hi, good morning everybody and thank you for joining us today. I'm Miles Roberts, the CEO of DS Smith, and I'm here with Adrian Marsh, our CFO.

So, this morning, we're very pleased to release a brief pre close statement, ahead of our year end later today. I'd like to make a couple of points by way of summary, after which we'll be delighted to take any questions you may have.

Our Group performance has continued fully in line with our expectations, driven by growth across our businesses and the ongoing delivery of synergies from SCA, so we're pleased. In summary, the market and business trends from our interim management statement in early March have continued.

Our like for like corrugated box volume growth has remained good, and ahead of our target of GDP +1%, and we've experienced particularly strong growth in Germany, and central and eastern Europe; this volume growth reflects market share gain from our increasingly strengthening customer proposition, driven by innovation and removing complexity and costs from our customers' supply chain.

Return on sales and return on capital employed have both continued to improve, as the benefits of our business model continue to flow through, so our outlook remains positive, and we expect continued performance in line with our medium term financial targets.

Thank you, I'd now like to welcome any questions anybody may have.

Op And, our first question comes from the line of Barry Dixon from Davy, please go ahead.

BD Yes. Good morning gentlemen, a couple of questions if you wouldn't mind. Miles, you talk about the positive performance in terms of volumes on corrugated, could you give us a sense as well in terms of what's happening with prices over the last couple of months? Clearly, I think there were some price increases achieved in December and January, but in the current environment of weakening container board prices, how easy or difficult is it to recover further increases in corrugated? You might just give us some sense as to how prices are, year to date.

The second thing, on your recycling business, maybe some thoughts around OCC pricing? We've seen some weakness in that of late, and maybe your own thoughts in terms of how you see the outlook for OCC pricing progressing for the rest of the year, and thirdly, you've identified Germany and central European markets as being strong, are there any areas around Europe that you're seeing, that you're disappointed in, in terms of volume growth on corrugated, thank you.

MR Thanks for that. You know, we have a short paper position, and when the price of paper goes up, we recover it with a lag, when price of paper goes down, we price that back to our customers, so it flows in and out, and the prices of paper have been increasing last year and we were recovering, exactly as we expected to. When the price starts to come off, we stop recovering and then in a period of time, those prices of packaging will fall back, and it goes up and down and we follow that. I think we've said many times, we have no idea where the price of paper is going to go, but we continue to insulate our shareholders from this as much as we possibly can.

The prices have come down, and we'll see where they go in the future, that's been in our testliner and we're also seeing significant weakness in Kraft as well, but we're not here to sell tons of paper, we're here to work with our customers and those price increases or decreases just flow through.

If paper prices reduce or stay as they are, we'll see a reduction in box prices, and if they go up, we'll see an increase in box prices.

What we are seeing, which leads onto your next question is increasing use of recycled. We've got a number of our major customers now only wanting to use recycled, they don't want kraft to be part of their customer proposition. I think that increasing the use of recycled is quite interesting, because the price of recycled has started to slightly moderate and come down, but the price of OCC, which is one source of fibre has stayed relatively constant.

As you know, we have a formidable recycling business, and we aim to get fibre from many sources, of which OCC is just one of those sources, so we are able to switch between different routes to get the fibre.

Where does OCC go in the future? We just don't know, I wouldn't be surprised if it stayed constant, it has been for the last 18 months. We see increasing use of testliner, if I had to make a prediction, I think that would stay relatively constant. It's notoriously difficult, whatever we say, it's usually wrong, so we'll wait to see, but there does seem to be an ongoing, good demand for recycled fibres, whether that's OCC, newsprint or other mixed papers, and as you know, we've got a formidable collection business, so we continue to have a good, readily available supply, but I wouldn't be surprised if it stayed constant, if I had to make a prediction.

In Germany and Eastern Europe, growth has been very strong. Which markets are disappointing? Well, there's no doubt we had some very poor weather at the beginning of the year in the UK and that was temporary, some of our customers had some production issues, so that has come back.

France remained a challenging economy, we are seeing some limited growth there, but there's no doubt that the industrial sector over the last few months has seen difficulties. The Industrial part of our business in France is about 20% of our activity there, it's 80% FMCG for us, so we are extremely resilient, but generally the economy is difficult.

But, in the rest of the areas, I think that's been much in line with our expectations, except for the UK weather for 6 to 8 weeks.

AM You see it in retail sales, so you've got a good look through to what happens to us to some extent, there was a very poor start to the year for the major retailers. You see that in all of the Cantos data that came out. No unsurprisingly if products aren't flying off shelves, then boxes aren't going on shelves as quickly either, so the UK was certainly slower at the beginning of the year, than we would have liked, and as Miles said, France is just a difficult market at the moment.

MR But, Italy has been surprisingly strong, as have Germany and Eastern Europe, Nordics for the year, so overall pretty much where we expect it to be, but there's always a little bit of a mix there.

Op And, our next question comes from the line of Catriona O'Grady from UBS, please go ahead.

CO'G Morning all. Three questions from me. Firstly, can you give us any guidance around what the market weighted GDP was for your Q4? Secondly, and the other side of Barry's question, were there any stand out or particular weak end markets, around the back end of the year?

And, thirdly, I know at the half year, you flagged that there might be some box capacity coming on line in Germany, have you seen that, and has there been any other competitive capacity changes, that have had any impact on pricing dynamics in any of your markets? Thanks.

MR We'll obviously get the GDP for our Q4 soon but we think it's going to be somewhere around 0.6, 0.7, that's our prediction. It has increased very modestly on the back of a European modest improvement. Again, we don't expect Europe to bound forward but this sort of GDP growth is within our range, so around about 0.6, 0.7%, slight uptick on where we were last year.

In terms of the end markets, there is this issue of where actual disposal income in a number of regions of Europe remains under pressure. It's certainly the case in the UK, more from the distribution of income issue, but that's replicated across a number of other countries, so even if you see average wages going up, at or just slightly below inflation, there is a distribution threat, and so generally we see the consumer under pressure in a number of regions.

I think probably the exception, you could argue, is Germany, where we're starting to see some quite high wage inflation coming through, but generally the end markets remain pretty subdued. They are improving, but it does remain pretty challenged, and you can see it in our collections of recycled, particularly across Europe, the discounters in the retail space tend to do pretty well. They're only a very small part of the UK, but everybody has obviously read about the effect that they're having on the multiple grocers, but that's not untypical of other parts of Europe.

So, we haven't seen any real weakening, it's just improving slightly, but there remains the general caution in the consumers, the only trend we're seeing is probably Germany, where wage inflation that is starting to outstrip general inflation, and to keep on Germany box capacity, there's more coming on in Germany.

I think we talked about this before, when we have very low interest rates across the whole region, you tend to get bubbles appearing, when the economies in some areas are strong, low interest rates, you get a lot of investment, particularly when there are some significant tax advantages for that, for private companies and we have seen investment go into Germany. I haven't heard of any new announcements in the last three months, but it's something that we expect, and will probably continue for a little while, but it's all within our expectations.

I think the new capacity that's come onstream has been announced in the last year is about 6-7% of the German productive capacity in box plants, so that's a bit of a nuisance, but it's probably about two or three year's growth and that comes on in stages, so it's a bit...it's never helpful but it's one of those things, and it's one market, and it's relatively modest.

CO'G That's great, thanks very much.

OP Thank you, and our next question comes from the line of David O'Brien from Goodbody, please go ahead.

DO'B Morning guys, just one from me, to go back to corrugated pricing, innovation is clearly an essential part of the business on the corrugated front for your customers. Against the backdrop of paper prices, how difficult is it going to be for you to actually get paid for that innovation, and we've seen innovation centres where you're now driving revenue as opposed to taking cost out, can you actually capture a margin from that process?

Secondly, please give an update on how the acquisition pipeline is looking and maybe finally, just a comment on the plastics business?

MR Yes, it's a great question. This pressure come from the consumer, I think we've spoken before, the old days of my costs have gone up, therefore I'm just going to push it through just isn't the order of today. You may have increasing costs, but if your customer can't afford to pay the price, you're not going to get it through and I think this is partly behind the reduction in paper prices; it is the end consumers who cannot pay.

Putting it bluntly, this is what we've been working on, the ability to take costs out of our customer's total supply chain is quite remarkable. Our volumes are growing, our return on sales is growing, and our return on capital is also growing and that is an indication of the value that we're able to start to generate for our customers.

It's not just about a new shape box, it's about their total supply cycle, and here we're finding a very, very strong reception, allied with a pan European footprint, as our customers want to consolidate their supply platforms, we're finding both of those are giving us very good opportunities to be paid for the value that we're adding.

Now, obviously if you have a product that's completely commoditised and anybody can produce it, there's very little innovation that you can really bring to add value, so on the tail end, it's always difficult, but we are finding our large customers increasingly coming towards it, and that's partly behind our confidence for the future.

And, in terms of the acquisitions, there are a number of businesses that are out there, that we're looking at, and the reason they are up for sale is because there's consolidation of the supply platform by our large customers. We don't see that going away, neither do some of our competitors, so there are a number of small acquisitions that are out there, and I think we will see some ongoing consolidation.

We're certainly pretty active in there, and we'll give the details of that, when we announce our results.

AM We're very focused on returns when we look at acquisitions, and on whether they're customer led or not, so we have across my desk, pretty much every week, you'll get an offer of a business for sale, but for us we have some reasonably strict criteria on whether we look at it at the moment.

MR It's not necessarily the actual assets, it's just a route to market for the technology that we're developing, that's what we find particularly attractive, a route to market and obviously we're establishing a lot more of the design centres rolling out, well over 20 and we're going to double that again. It's all about route to market for our technology.

You talked about plastics and here, we are seeing again a good performance. There's increasing demand for the bag in box solution, the recycle proposition of that is easy to use, and the best transportation costs for the finished product, we continue to see that growing, and indeed, we've got quite a bit of investment going into that at the moment.

It's not quite a new factory because we do already have a footprint, but we are trebling the size of one factory in Europe, and increasing the size of another at the moment, just to cope with the increasing demand, and again we don't expect to see that go away, we expect to see that continue to develop over the coming years. Again, we're very pleased with that, and we should see a good development there as well.

OP Thank you, And, our next question comes from the line of Justin Jordan from Jeffries, please go ahead.

JJ Good morning everyone, I just want to ask two specific questions, if I could please? When you talk about improving return on sales, and I'm referring particularly to Germany and central and eastern Europe here, which you're alluding to in the statement, are you alluding to a sequential improvement in the second half fiscal 2014, or the first half fiscal 2014? I'm just trying to get a bit more colour of the improving return on sales, and secondly, just in terms of the cash flow, can you give us some guidance as to what the restructuring costs that have been incurred in the second half of fiscal 14? I'm trying to think in terms of what the working capital is, given the strong performance in the first half of fiscal 14, and what I'm working to is some sort of idea of where net debt at year end has been in relation to the 773 it was at the interim stage.

MR I'll talk about this and Adrian, are you happy to talk about the cash flow? Let me talk about the return, we are talking about the group for the full year, relative to last year, but in fact, even if you break it down to the first half/second half, you'll see an improvement on both of those, on last year for the group overall.

When we look at the breakdown we give you, in terms of the regional segmentation we provide, you're going to see an improvement on both of those again. I would have to check, but I'm pretty sure you will again, first half, second half and over last year. We haven't finalised results, but I'm pretty sure we're going to see a further improvement there, first and second half, over last year, yes. I think we are seeing improvements on both of those regions as well. We haven't finalised year end results.

JJ I appreciate that, to be very clear here, the DACH operating margin was presented at 8.5% in the first half, are you saying that's improved in the second half, and similarly that central and eastern Europe was 7.8 in the first half, has that improved in the second half?

MR We haven't got the final for this month, I think it will be but I can come back and just confirm. The reason I'm slightly hesitating is purely because of the paper. We have some paper in the DACH region, and it's just how that flows through. I'm pretty sure we'll see an improvement, but we'll come back to you. It's just this mix issue is where I'm slightly hesitating.

JJ And then, on working capital?

MR Your question on that was, are you expecting a significant improvement again in the second half?

JJ I think 3.6% in the first half is a pretty solid performance, but I'm just wondering what the second half performance has been, and any other factors we should be thinking about in terms of second half, working down towards the net debt number at the year end.

AM In terms of working capital, I wouldn't be anticipating an improvement over the half year, I would be looking at a continuation, and in terms of net debt, at the half year when we described it, we weren't predicting material changes from where we were at the half year, other than that we're focused on improving. I don't know if that helps you at the moment.

JJ One factual number, what was the cash restructuring costs incurred at the second half of the year?

AM I think you will have to wait until we've got our results up.

OP Thank you and, our next question comes from the line of Alexander Mees from JP Morgan, please go ahead.

AMees Good morning, three quick ones, I hope. Just firstly, could you tell us what the mix between FMCG and industrial and how the trends are there? Secondly, I wonder if you wouldn't mind commenting on shelf ready packaging, we haven't heard much about demand trends in shelf ready for a while, can you give us an update?

And then, thirdly, back on the earlier question on acquisitions, I wonder if you could just explain whether your priority is for infill or new markets, and if there are any particular markets you're focused on too.

MR Yes, it does continue to improve on FMCG, so last year we were about 60%, and this year will be better than that. Again, we have to wait for the analysis of year end, but the figures are over 61+, that's where our growth is coming from, but because it's very resilient, in the downturn, it doesn't go down, but when economies improve, there is a pick up, but it's not as if we're behind the housing sector. So, we like to think of our growth as good quality or sustainable growth, building in these strong categories and not riding on the back of a housing boom. So, we'll see an improvement there, and we're very pleased about that.

In terms of shelf packaging, it's absolutely fascinating. Adrian joined direct from Tesco, and he luckily confirms what we've been saying, and here we really see a number of trends in the final markets, one of which is in the convenience sector, and the significant growth there, so we're seeing not only in the UK, but in other parts of Europe, with the ongoing urbanisation, an absolute focus on shelf packaging. We're seeing very strong growth in shelf ready packaging, particularly in the convenience sector, because the stores are so small, the product has to fit exactly where it should go, it needs to be very easily replenished, because you can't have a lot of staff milling around in a modestly sized store. So, we're seeing a huge push in shelf ready packaging, but particularly in the convenience sector, and we're getting the growth.

The other area for shelf ready is in display. Advertising isn't anywhere near as powerful for the brand as it was in previous years. More promotion activity, more at the point of display, it's about the communication of the product to the consumer at the point of purchase, so we're seeing again a lot of growth in this display format, which again is very akin to shelf ready.

Outside that, the other area we're seeing as a consumer trend is obviously in ecommerce. There, if ecommerce is built on picking from the store, which some very large retailers employ as a model, that doesn't have any material effect on us, but when you're into the Amazons and similar companies, there we're getting very strong growth in our volumes, and product development is going into some of those categories.

So, we think shelf ready is going to continue to grow, and you're going to see a lot more self merchandising units which basically push the product to the front of the box, there's a lot of technology there, and I think that's a really exciting area. You're going to see a lot more over the coming year, in the convenience sector, more display, and ecommerce, and in all those areas, we think we have a significant advantage over our competitors.

AM I was in Italy a couple of weeks ago, which is probably one of the least adopted shelf ready markets in Europe, and we've got an innovation centre in Tuscany, that was entirely set up to demonstrate to customers the benefit and the power of it, and it's only been up and running a few weeks now, and already they've been bowled over by the response from customers, who just had not either considered it or taken the time to consider it, or had assumed that it wasn't relevant for the Italian market, so on top of margins, we still have in Europe, late adoptive markets which I think can convert too.

Do you want me to do the M&A one? In terms of M&A, whether our focus is on infill or new markets, and we have a small team in the centre, focused on business development. Clearly, where our customers are asking us or putting pressure on us to infill or to improve or increase capacity in markets we're currently in, that's an area of focus, that there's no doubt about and the team is spending a lot of time on that.

In terms of new markets, you would expect us to constantly be challenging ourselves about whether we want to go into new markets or not and what the relevance is and what sort of returns we'd need to make, and what opportunities there might be there to do something with this gap. I have to say as it stands today, there isn't anything that we're feeling very positive about in terms of being able to tick all of the boxes, ie have an ability to generate the required return on capital for us, in their required time frame and is customer led, ie with having pressure put on us by customers, but we are looking at it.

In terms of infill, clearly that's the easier one for us to evaluate and put effort behind so we are.

AMees Thank you, I look forward to that.

OP Thank you, and our next question comes from the line of Hector Forsythe, from Oriel, please go ahead.

HF Morning guys, a bit of a wrap up one for me, can you just give us an update in terms of how you're developing your closed loop strategy in continental Europe, that's less developed than in the UK, and how that all measures with where you are in terms of your paper strategy, and where you've got to in terms of redefining the amount of production you have?

AM Absolutely, as you know, in the UK we have a closed loop model, we pick up from all the major retailers in the high street, all the old corrugated cases, and we really work with those retailers to maximise the yield from their stores, and indeed, we work with a lot of other customers on all this closely. Nothing goes to landfill, and everything is logged and we'll keep it inside the territory, if that's required by the customer.

The challenge for us is how do we increase the yield of fibre from Europe, and so we are establishing our position on the continent. We've made some very good forward moves which we will outline in our full year announcement; it does involve some very nice assets which we're bringing in. We've highlighted France, Italy in Europe before and we're pleased with the progress there.

We have brought in a number of major retailers, with some assets but we really see this model continue to grow as we're able to improve the yield of fibre, to increase the supply of OCC, so that we can ensure that our customers have a ready availability of tech liner, which is increasingly the product of the format of choice by the end consumer, but we're pleased with progress there, coming on quite nicely.

HF Part of that is your wanting to reduce your own paper production, do you want to give us an update on that, if you can?

MR If we can come back at the year end, but we're very busy on that.

HF Thank you.

OP Thank you and we have no other questions.

MR Right, just a final few words. In summary, we're pleased with the performance of the business in the year to date, despite market conditions that do remain challenging. The business model is shown by the continued increase in our volumes as customers seek to consolidate their supply bases. We are a complete service, from design to production, right through to supply and recycling, delivered across Europe, gives our customers the opportunity to package their products in a recycled, cost effective material, that provides consistent quality in both the supply chain and retail environment.

We continue to see opportunities for growth in this market, and are optimistic about the prospects for the business in the future, so thank you very much for you taking the time to dial in today, and obviously we look forward to meeting you on our full year announcement on 26 June, so from us here, thank you very much for your time.