DS Smith Q1 IMS Conference Call

3 September 2013

Speaker key

MR Miles Roberts
BD Barry Dixon
KOG Catriona O'Grady
MM Mike Murphy
JT Jake Thompson
DOB David O'Brien

Op Operator

Op Good morning ladies and gentlemen and welcome to the DS Smith Q1 IMS. My name is James and I will be your coordinator for today's conference. For the duration of the call your lines will be on listen-only. However, you will have the opportunity to ask questions at the end of the call. If at any time you need assistance please press star, zero on your telephone keypad and you will be connected to an operator. I will now hand over to Miles Roberts to begin today's conference. Thank you.

MR Good morning everybody and thank you very much for joining us today. I'm Miles Roberts, the CEO of DS Smith. This morning we're pleased to release our Q1 interim management statement. I'd like to take a few minutes to run through the highlights of that statement, after which I'd be delighted to take any questions that you have.

It's been a good start to the year. We are encouraged and every part of the Group is showing improvement. This is partly due to the continuing, strong delivery of the previously announced synergies from the SCA Packaging acquisition, together with ongoing, underlying improvements. In terms of the trading, as I said, the current year has started well, fully in line with our plans to-date. The return on sales and return on capital employed have also continued to improve, all as anticipated. The packaging business has performed well and, whilst the European markets remain challenging, our volumes have continued to improve. And again our volume growth has been well, fully in line with our GDP plus 1% target. And this reflects the increasingly positive customer reaction to our differentiated and strong value proposition as we leverage our enlarged and strengthened geographic footprint.

And with regards to the outlook, our overall outlook remains positive and we continue to grow our business and deliver the synergies from the SCA Packaging acquisition. We expect to perform in line with our medium term financial targets and we view the remainder of the year with some confidence. We have a pre-close, half year update scheduled for 1 November and, just to remind you, Adrian Marsh starts as the new Group Finance Director at the end of the month.

Now I'd like to - apologies, Adrian will join us at the end of September - welcome any questions you have. Thank you.

Op Our first question comes from the line of Barry Dixon from Davy. Please go ahead.

BD Good morning Miles. Two questions, if I could? In terms of container bulk prices what we're hearing, anecdotally at least, is the price increase that was announced in August has gone through. How soon do you expect to see that coming through in corrugated prices?

The second question is related to volumes and you sound positive and it's good to hear it in terms of the outlook part of the business. Looking at the different divisions either Western Europe or Central Europe and Italy or Western Europe or UK, could you give us maybe some sense by region how the volumes are developing? Thank you.

MR Our volumes have actually continued to improve pretty consistently now for some time for the Group overall and we're seeing those volumes rise not just in absolute terms but in relation to GDP. And if we look at the regions we have seen, broadly we've seen growth in all the major markets. Some of the smaller markets have been a little bit more challenging, places like Belgium pretty much slowing the economy, but in all the major markets we've seen regional growth and that includes Italy, Germany, France.

I think it's particularly true that our position in Central and Eastern Europe where we have, where we've seen a strong growth for some time, that's continued and that's actually accelerated as well. So pretty much across the board, a few smaller economies perhaps a little bit more challenging. I think they really are local issues. But, as I said, it's been improving and not just in absolute but relative to GDP as well. And, as I say, this is with an increasing return on sales and an increasing return on capital employed, so we're not… we value what we produce and also our customers do, as well.

In terms of raw material costs we have seen some increases in, it's really, it's predominantly a little bit on energy recently and some of the testliner prices - this is recycled paper - have also increased. And in terms of recovery, in the old DS Smith business it's typically about three months. Some contracts are earlier than that, a few are later, but it's typically three months and the ex-SCA businesses moving towards the three months. I think on average we're about four at the moment, something like that and that's what we put in here. Whilst some of these costs have gone up, which we expected, some raw material costs have increased, and we will recover them in due course as we always have. But the increasing return on sales, etc, that we have achieved was obviously before those increases came through.

BD Thank you very much.

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

COG Morning! Just two quick questions from me. Could you give a bit more colour on any particularly strong or weak end markets in terms of whether industrial is holding up a bit better and the trend you're seeing there? And secondly in terms of the recent paper price rise, just any colour around whether or when we could start to see that benefiting your paper operations. Thank you.

MR If we look at, as a Group there's… obviously as the European economy shows a slight positive outlook the first point of that will be the upswing in some businesses that have really been hit very hard over the last few years. And things like construction obviously spring to mind. In DS Smith it's about the quality of the growth and we're very focused on the FMCG sector because of the consistency of volume. Our volumes in that sector have never gone down, they've only ever increased. As a company there is and I think that there probably will be more of an uptick in some of the more cyclical areas, but as a Group we're very focused on, as I call it, getting quality growth. Ours is predominantly on FMCG because that's where we're heavily focused.

When you look at the industrial sectors that again we, where we are working, and we have seen a slight improvement in some areas such as construction where we have very limited exposure to it. Those are areas that have been reasonably strong, say in the UK there's automotive; across Europe aeronautics have been strong. There are a few cyclical upswings but we're not… we need to get the right quality of those so that whatever happens to the economies in the future we've built our business on resilient parts of the market.

And in terms of the increase in paper price, and we do obviously have a paper business, and that benefits it immediately. As the prices rise obviously the price of fibre has also risen. This is what we mean by raw material costs. Paper goes up, you have to pay more for fibre, but the profitability in paper improves. That is, that's happening now. That has an adverse effect on packaging, but then packaging recover those costs in the, over the coming months. And that's what we mean in our statement where we say there's customary lag, because it does take us a few months to actually improve again the overall margin of the Group, because at the moment it's just paper to packaging. Because we're short on paper there is actually a slightly adverse effect, but such is the growth in volume and the synergies we are, we actually, as I've said, we're actually seeing an improvement in return on sales despite all of that. This is what we mean by a good start to the year.

Op And our next question comes from the line of Mike Murphy from Numis Securities. Please go ahead.

MM Morning, guys. You've answered two of the three questions on volumes and prices. Can I talk a little bit about the longer term? Clearly now you've… the SCA synergies are coming through. Are you turning your attention to further consolidation of the European market? And secondly, on the other side of that, can you give us any update in terms of where you might be in terms of disposals of some of the SCA businesses?

MR The, in terms of the business, and we're absolutely delighted with the integration, but what we're finding is we're putting a lot of work into the commercial side because our customers are crying out for some leadership in this industry. And I have to say there's been an extremely positive response. And so there is a huge amount of work in the underlying, organic growth of the Group and it's improving. There's a lot of work there. But you're absolutely right, Mike, there is, there are a number of opportunities there and we are talking to a number of people. It's always difficult to know when these things will happen, but the team is in place and obviously I think we've shown how we can integrate and get the customers and all the employees and the environment right for this and so we are talking. I don't think there's anything imminent, but we are certainly turning our attention to the next stage of growth and we think there are some very good opportunities.

And obviously when you've had a successful acquisition where the customers respond well, the employees, the works council, it just, it makes it, it makes you very attractive for other companies to want to join, for they only have to talk to the guys who are working in DS Smith who've joined through acquisition. Perhaps you go and talk to them and just talk to them about the experience that they've had and how they've become part of the Group and that sells itself. It's quite interesting a lot of the integration that we've been doing, if you go to France most of that is actually run by the ex-Otor people and they're our greatest advocate. So we are very positive on that and we are out talking.

We're very disciplined on the returns that we want, the returns on capital, so here we have industry-leading returns that are improving and we have to make the right return for our shareholders. A bit of a long answer to your question. There are opportunities there. We are active. We think we're attractive. We're disciplined in the approach, but I wouldn't underestimate the organic part that's coming through, as well. We're encouraged by that.

MM And can I just, a supplementary question on the previous answer on pricing? You talk about an average of four months, can you give us… SCA I understand used to be or was actually six months in terms of getting the pricing coming through. Clearly you've been talking to some of SCA's customers for a while. Have you been able to convert many of those that have come up for renewal to a shorter time period?

MR Yes. Just as we did with DS Smith some years ago where typically we were six months, we then brought it to three. This is beneficial for our customers. It's not, we're not here saying, do you want to second guess the price of paper? We just don't know what's going to happen. It's a notoriously unpredictable business. And therefore the pass through of these costs is something that we're keen to see and increasingly our customers are, as well. And I think they want the packaging solution, they want the real innovation, they don't want us to be there trying to second guess their paper prices.

So it's by no means over. Not every customer is in that, is in the camp. That's just this, that I've just described them, but the majority of them are and so they are being transferred over. And to be honest with you we get very little resistance from it because it's in, it's actually in their interest, it's in our shareholders' interest, it's the right policy. And I have to say over the last few years nothing has happened, it's the ups and downs, [several unclear words] it's, and we'll see, our shareholders will see the benefit of that over the coming months.

MM That's great, thanks a lot.

MR Not at all!

Op Our next question comes from the line of Jake Thompson from Odey. Please go ahead.

JT Hi there! Good morning Miles. Thanks for taking my call. Just two questions really on the margins following up to earlier comments. Can you give me a bit more detail on how you've been able to improve your operating margins despite the testliner pressures from the February increase? Given a four month lag and the February increase it's, I'm just wondering how you were able to improve margins in May, June and July. And could you give colour on those synergies and volume leverage one to 2%, because it seems quite a neat feat.

And the second related question is given what Barry mentioned in the August price increase how… what's your view on your ability and timing to pass that through? Presumably if it's going into the rest of the calendar year that's going to be another significant cost pressure you'll try and overcome, as well, so a bit more colour on both those points would be really appreciated, thank you.

MR Not at all. The margin improvement is, it comes from a number of areas. Firstly we, all the time we try to improve the mix of business and we have, as we explained last year, that growth that we're talking of is actually net of the business that we have exited that we don't think is attractive to our customers. And it's better that other suppliers supply it where it's very low margin and commoditised. It's really, it's not the best use of our assets. So the business mix is improving. It's partly behind what I was talking about earlier, this quality of growth. It's not the absolute growth it's the quality of the growth that you're getting. Things like cyclicality and the margin that you get from it. So firstly we're getting a small mix improvement.

Secondly you've got the operational leverage that you've talked about where you do get volume growth. We have, the overheads are actually coming down and we obviously have a gross margin coming through. And the last part of it is the, are the ongoing cost improvements, including the SCA synergies, and as a result of those our margins have been improving. And I think this focused discipline on the type of growth, what's really adding value, culling what we call the tail. So we're not just interested in growth and, by the way, the margins have fallen, it's about quality of growth.

And then when we come back to this, paper prices have increased, we do have a paper business, we're short in paper so we have had an overall negative effect but this has been offset by these other issues. But as the indices trigger and as we talk to our customers about the increases that we're going to see, we certainly anticipate we'll be able to raise the prices for our packaging business fully in line with our expectations. I have to say it's been quite a, just as an industry, the price of raw materials and paper, it's been quite a challenging time the last ten, 12 months, it's certainly hasn't been an easy time by any means either in terms of profitability of things like paper, the end markets. And obviously we don't plan for it, but it would be nice to start to see the end markets lifting up a bit and start seeing the profitability of things like paper improving. That would certainly be beneficial.

JT I have one more follow up, if you don't mind, Miles. In terms of your UK paper assets you have Townsend Hook mills for Smurfit Kappa being rebuilt and turning off for the next couple of, the next few months. What positive impact does that have on your business? And then what is the, could you quantify the negative impact on your business as presumably your assets move up the cost curve when that is turned on again? Thank you.

MR In terms of what you… that short term capacity that is coming out, that's right, 250,000 tons, the thing with paper is what you effectively have is a commoditised product and the markets in which the over supply/demand balance for it, it's not completely but it's broadly on a European basis. Iberia is a little bit different and for Europe is a little bit different, but for central France, Germany, the UK, you can just move the paper around. When you look at a mill coming out, something like this one you've alluded to and in fact it's going to be rebuilt and so capacity will come back, if you look at that you've got to look on a European basis and if it's 250,000 tons as a proportion of the market it's only going to be a small percentage. But obviously it's going in the right direction to the supply.

The thing is if it's 250,000 tons out of a 20 million ton market you only need mills to run an extra couple of percent for various reasons, perhaps lower down time, and you're going to be able to recover that volume. So I don't see there being a dramatic effect and, of course, this closure follows the opening of a new mill by a privately owned company in the UK that's added capacity to the UK - certainly capacity coming out helps. I don't believe it's a structural change. It may have a very short effect in a very local area for a very limited amount of time, but I don't think it will change anything fundamentally.

I should say in terms of our cost base the 250,000 tons our mill at Kemsley which is the largest mill in the UK and Europe's second largest mill, 850,000, we really don't have an issue at all with where the cost base is. You've got to operate these assets at their optimum point at their lowest cost, but their lowest cost relative to other businesses. There is an awful lot around the size of the assets, the technology, your power solution, the access to fibre and a number of those things are actually to do with the UK and the UK market. We are quite confident about our profit position and if a new mill comes back in the European markets I don't think it - it just will or it won't - will have a significant effect on us.

JT Thank you Miles.

Op We have one further question. It comes from the line of David O'Brien from Goodbody. Please go ahead.

DOB Hi, Miles, David O'Brien from Goodbody here, just two from me, if I may? Firstly, you allude to market share gains in this statement. Could you give us an idea and quantify the level of performance there? And secondly, just piecing together your comments around, on the other regions, would it be fair to say the UK volumes have lagged slightly the European businesses as a whole for the corrugated side?

MR We've done better. GDP for our regions was about flat and our volumes have been certainly above 1% growth, so we are actually a bit better than the GDP plus 1%. But it is just only one quarter. That's all I would caution on. But we have done better than that. The UK's volumes in the period are broadly flat. It's one quarter. The overall UK markets haven't shown any particular signs of life. It's okay, but it's perhaps showing a little bit more encouragement very recently, but all of this, just a bit of caution that it is one quarter. And our business is very focused on FMCG. This is food and drink. And there could be a housing and a construction uptick, but we're just not really focused there.

I say again, in our growth we're after quality of growth, growth that we see consistently coming through. And many economies that will have some more challenges in the future, which I'm sure they will, our shareholders know that our volumes are going to hold up and they're resilient. It's not chasing the here today, gone tomorrow, type of work.

And in terms of the share, again what we really have here is a turnaround in the ex-SCA business. We've, we had a business that really wasn't going very… really wasn't going anywhere and now we're able to put ourselves on a pan-European basis we've seen our large customers really respond to that. They told us they wanted a pan-European supplier. They told us they wanted leadership in the industry. We formed this business and they are rewarding us. I'm looking not only at the data I'm looking at the countries and it's encouraging and an awful lot of it comes, as I said before, from the, from that whole central, Western European business. And it's nice to see it. But, as I said earlier, Belgium, which is a very local market, had a few issues.

DOB That's great, thanks very much.

MR Not at all.

Op We now have no further questions coming through so I'll hand you back to your host to conclude today's conference

MR Firstly everybody thank you again for your time. We do appreciate it. And just to reiterate, the current year has started well; it's in line with our expectations. Return on sales and return on capital employed have both been improving and our overall outlook remains positive as we grow our business and deliver the synergies. And we view the remainder of the year with confidence. Thank you for your time.