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Research Update:

U.K.-Based Paper Packaging Producer DS Smith PLC Assigned 'BBB-/A-3' Ratings; Outlook Stable

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Table Of Contents

Overview

Rating Action

Rationale

Outlook

Issue Rating Analysis

Ratings Score Snapshot

Related Criteria And Research

Ratings List

Research Update:

U.K.-Based Paper Packaging Producer DS Smith PLC Assigned 'BBB-/A-3' Ratings; Outlook Stable

Overview

- U.K.-based paper packaging producer DS Smith PLC has a strong position in the European corrugated packaging market, supported by relatively stable and fast-moving consumer goods end markets, and the proximity and diversification of its customer base, contributing to our assessment of the company's business risk as satisfactory.
- We view DS Smith's financial risk as intermediate, reflecting our projection that its Standard & Poor's-adjusted debt to EBITDA will remain below 3x, with funds from operations to debt forecast to increase to above 30%.
- We are assigning our 'BBB-/A-3' long- and short-term ratings to DS Smith.
- We are also assigning our 'BBB-' issue rating to the company's new €2.5 billion European Medium-Term Notes program.
- The stable outlook reflects our view that DS Smith will continue to generate substantial positive free operating cash flow over the next two years, on the back of volume increases exceeding GDP growth and stable or slightly improving margins. We consequently think the company's credit metrics will stabilize within our intermediate financial risk profile category.

Rating Action

On March 10, 2015, Standard & Poor's Ratings Services assigned its 'BBB-' long-term and 'A-3' short-term corporate credit ratings to U.K.-based paper packaging producer DS Smith PLC. The outlook is stable.

At the same time, we assigned our 'BBB-' issue rating to the company's senior unsecured €2.5 billion European Medium-Term Notes (EMTN) program.

Rationale

The ratings on DS Smith reflect our assessment of the company's business risk profile as "satisfactory" and its financial risk profile as "intermediate." Our ratings also encompass our view of the company's "strong" liquidity and "satisfactory" management and governance.

Our view of DS Smith's business risk profile as "satisfactory" reflects the company's market position as the second-largest paper packaging producer in Europe. DS Smith has an estimated 14% share in the relatively stable corrugated box market, with some potential for demand growth. The company also

has a growing position in the plastic "bag in box" packaging market. Our assessment of DS Smith's business risk reflects the company's exposure to well-diversified and consumer-oriented end markets, with the stable, fast-moving consumer goods (FMCG) segment representing about 60% of company revenues.

We consider the paper products industry as cyclical, fragmented, and competitive. DS Smith is somewhat exposed to volatile raw material costs and periods of overcapacity, leading to pressure on pricing. However, this is mitigated by DS Smith's contractual cost pass-through structure, which allows it to pass on input cost increases to customers with a short time lag. The company also relies on client proximity with its "closed loop" operating model, whereby it collects and recycles cardboard boxes from retailers. DS Smith's "satisfactory" business risk profile also incorporates our view of the company's strong focus on quality and product innovation, with recurrent investments in its asset base and design centers, as well as the provision of personalized services to its customers.

We view DS Smith's geographic diversity as a slight weakness when compared with that of its global peers, due to its predominant focus on the European market and no access to high-margin and low-cost emerging markets. We also view DS Smith's Standard & Poor's-adjusted EBITDA margins as weaker than for paper products peers. We believe this is due to DS Smith's focus on higher-volume and lower-margin customers, typically in the FMCG sector, as well as its relatively low vertical integration compared with some paper packaging peers (the company's strategy includes being significantly short on paper) and its lower-margin recycling segment. The recycling segment is nevertheless of strategic importance in supplying recycled fiber to DS Smith's mills and box plants. The company's relatively low absolute profitability is partly offset by the relative resilience of the packaging end-markets in which it operates, translating into what we view as satisfactory volatility of profitability through the economic cycle.

DS Smith's "intermediate" financial risk profile is supported by strong cash flow generation and a consistent financial policy that has resulted in relatively healthy credit metrics through the economic cycle. We expect that the company's dividend policy will remain unchanged, at a ratio of earnings to dividends of 2.0x-2.5x over the cycle.

In our base-case operating scenario for DS Smith, we assume:

- GDP growth in the eurozone (European Economic and Monetary Union) of about 1.0% in 2015 and 1.4% in 2016.
- Modest revenue decline in 2015 (financial year ending April 30, 2015) mainly due to foreign exchange translation losses, followed by organic revenue growth of about 3% in 2016. These forecasts reflect our expectation of slow economic improvement in the eurozone, as well as an increasing focus on higher value-added segments.
- An EBITDA margin of about 11.0%-11.5% in 2015 and 2016, supported by input cost pass-through mechanisms and continued cost rationalization.
- Annual capital expenditures at about 4% of revenues.

- Dividend payments of about £100 million in 2015, increasing gradually with earnings but remaining commensurate with the company's 2.0x-2.5x dividend coverage policy.
- No significant acquisitions, other than the announced agreement to buy Austrian packaging producer Duropack for approximately €300 million in 2015.

Based on these assumptions, we arrive at the following credit measures for DS Smith:

- Adjusted debt to EBITDA increasing slightly to about 2.8x in 2015 from 2.7x in 2014, and improving thereafter toward 2.3x.
- Adjusted funds from operations (FFO) remaining relatively stable in 2015, versus about 28% in 2014, and increasing to more than 30% over the following years.

Liquidity

The short-term rating on DS Smith is 'A-3'. We assess DS Smith's liquidity as "strong" under our criteria. We expect the company's liquidity sources to exceed its uses by more than 1.5x over the next 24 months, supported by healthy cash balances and full availability under its committed revolving credit facility (RCF) that we expect will have covenant headroom somewhat over 30%. In addition, any issuance under the company's new EMTN program would further extend the group's debt maturity profile and support our liquidity assessment.

We estimate DS Smith's principal liquidity sources for 2015 as:

- About £98 million of cash that we consider unrestricted as of April 30, 2014;
- Our assumption of ongoing access to a RCF of £800 million (undrawn at year-end 2014); and
- Free operating cash flow (FOCF) of about £200 million.

This compares with the following liquidity uses for the same period:

- Dividend distributions of approximately £90 million-£100 million;
- Short-term debt maturities of just over £100 million; and
- Intra-year working capital swings of about £60 million.

Outlook

The stable outlook reflects our view that DS Smith will continue to generate substantial positive FOCF over the next two years, on slightly improving profitability, despite a weak operating environment and currency headwinds. We consequently think the company's credit metrics will stabilize within our "intermediate" financial risk profile category.

Downside scenario

We could consider a negative rating action if DS Smith experienced severe margin pressure or poorer cash flows than we anticipate, leading to weaker credit metrics--for example debt to EBITDA of more than 3x, and FFO to debt

below 30% on a sustained basis. Changes in the company's financial policy to accommodate significant debt-funded shareholder distributions could also trigger a downgrade.

Upside scenario

Ratings upside is limited in the short term because we believe that DS Smith's financial policy will limit material deleveraging. However, we could consider raising the ratings if we believed that DS Smith could sustain debt to EBITDA at the upper end of our "intermediate" financial risk profile category, specifically, FFO to debt exceeding 40% and adjusted debt to EBITDA of about 2x.

Issue Rating Analysis

We apply our structural subordination analysis to DS Smith's EMTN program and future issuance. Although there is no significant prior ranking financial debt in the capital structure, the company has sizable trade payables that we view as effectively senior. Our concerns over structural subordination are mitigated by significant cash balances at the parent level and intercompany loans made to subsidiaries. However, if the cash and loans significantly reduce, they could put downward pressure on our issue rating on the EMTN program.

Ratings Score Snapshot

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

Business risk: Satisfactory

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

Related Criteria And Research

- Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Key Credit Factors For The Forest And Paper Products Industry, Feb. 12, 2014
- Corporate Methodology, Nov. 19, 2013
- Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Group Rating Methodology, Nov. 19, 2013
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- 2008 Corporate Criteria: Rating Each Issue, April 15, 2008

Ratings List

New Rating

DS Smith Plc

Corporate Credit Rating
Senior Unsecured

BBB-/Stable/A-3
BBB-

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