DS Smith

Q3 Trading Update

Thursday 10 March 2022

Participants

Miles Roberts – Speaker

Adrian Marsh – Speaker

Cole Hathorn – Jefferies

Mikael Doepel – UBS

Kevin Fogarty – Numis

Justin Jordan – BNP Paribas Exane

David O'Brien – Goodbody

Brian Morgan – Morgan Stanley

Sam Bland –J.P. Morgan

Sean Ungerer – Chronux

James Twyman – Prescient

Miles Roberts: Good morning everybody, and firstly, thank you for joining us on our call this morning. As introduced, I'm Miles Roberts, the group's CEO. We're also here with Adrian Marsh, our group CFO. Our statement today covers the trading for the period since the 1st of November 2021. I'd like to start by saying that despite the increasing macroeconomic and geopolitical uncertainty, I'm really pleased with the continued momentum during H2, with the expected good progress in profitability and cash generation and of course, I'd also like to thank everybody who works in DS Smith, really for their continued commitment; professionalism and support in what really are quite extraordinary times. So, during this period, we've had good volume growth despite some very tough comparatives and some localized short term Omicron driven absences within DS Smith, but actually more so in our customers. Growth has been fastest in our largest customers where they continue to see this security, our supply, our service and our innovation as crucial and we're also seeing good momentum from a focus on more sustainable packaging. Regionally, growth has been especially strong in the U.S. and also in Eastern Europe and overall, we're expecting volume growth for the full year to be well in the mid-single digits. Input costs including energy and labour continue to increase with OCC prices remaining high, reflecting the on-going strong demand levels. The energy impact has been limited by continued focus on really good energy efficiency and in particular our long-term hedging program. We have had high levels of hedging for energy throughout the current financial year and this does continue into the next financial year as well, but we continue to successfully recover these rising costs through increased packaging prices and we expect this to continue. Consequently, our overall trading

continues to be in line with our expectations and the profit growth is translating into cash and as such, we anticipate another strong free cash flow performance for the full year, with cash conversion well over 100% and a further reduction in our leverage from the 1.9 times reported at the half year. So, in summary, over many years we built a business, this ideally positioned from the long-term structural growth drivers of fiber based packaging, exemplified by the e-commerce and sustainability and governance trends. Whilst we continue to operate in these uncertain times, we are operating develop markets with a resilient FMCG customer base and remain confident about the prospects for the business for this financial year and beyond. So, thank you and I would now like to invite questions which Adrian and myself will answer between us. Thank you very much indeed.

Operator: As a reminder, if you would like to ask a question, please press star one. The first question comes from the line of Cole Hathorn from Jefferies. Please go ahead.

Cole Hathorn: Morning Miles, morning Adrian, thanks for taking my question. Just firstly, focusing on what's going on in the wider paper market with energy prices, we've seen some players in Italy take commercial downtime because gas prices are quite elevated and I'm just wondering how this plays out in the market. Do we effectively get a position where we're getting reduced supply and it pushes up pricing and then you're able to price up your boxes beyond that, is the first question, and the second is related to that, will this have any impact to DS Smith, considering you do source from some of these smaller players out there in the market? Just wondering how your security of suppliers and related to that, do you think this is an opportunity to take share? Effectively being the bigger player, yourself and Smurfit taking share versus the others because you've got paper and able to service your customers? Thank you.

Miles Roberts: Thank you very much, Cole. You're right; the paper market is having a really difficult time. There's no doubt the increase in energy and OCC and starch costs, I think has really hit a number of suppliers there in our position on paper. We try to have a short position that really is playing to our strengths, my goodness me. We have seen some supplies, some smaller supplies, stopping production because the energy costs, its other costs are so high that is not affecting us. We have long term supply agreements with a number of very long-term suppliers and all of them continue to supply us and have reiterated that in their contractual agreement. So, we don't see any issue with supply. In terms of pricing, we have seen some very recent announcements on paper price increase and frankly, I fully expect that to continue. The paper industry is in a difficult position and it does have to raise pricing. Now you've seen that in terms of DS Smith with our security of supply, with our market positions and our coverage and our levels of service. You have seen us really consistently take market share over many years. Demand for our products remains strong and I absolutely expect us to continue taking market share this year, but in the coming years. Thank you.

Operator: The next question comes from the line of Mikael Doepel from UBS. Please go ahead.

Mikael Doepel: Thank you. Firstly, on the containerboard markets, just wondering if you can get a bit more colour on the dynamics there. I understand the situation with some high-cost producers stopping production in this environment, but what do you see in terms of import, exports currently? We have seen in statistics the U.S. craft liner imports into Europe

have been growing a bit. What trends do you see there and also on the export side of things, what's going on? Also there on the inventory levels in the value chain if there's anything you could say about that and also finally on the same point, Russian exports of craft liner, do you see those coming to a halt or what's going on there? Thank you.

Miles Roberts: If I take those together but thank you for the question. With Russia, we understand they export about 300,000 tons of craft liner per annum to Europe. It's quite difficult to know exactly, but we think it's about that level. So, it's quite a small part of the overall market. In fact, the new capacity coming on stream this year from more European based producers is actually more than Russian exports. There's no embargo on those exports. We note the move of the FSC to remove their accreditation from Russian supplies, but of course, a number of the Russian suppliers aren't covered by FSC anyway and indeed a number of the customers for that craft paper may not themselves be FSC compliant on certain products. So, at the moment, with the no sanctions, it is too early to tell what's going to be the medium term effect, but I don't expect it to be significant. We ourselves, we buy a miniscule amount of paper from Russia and that's already been ceased, and we just moved to alternative supply. So, we'll have to see. I should say, I think the wider impact may not be on craft paper. We are watching sort of the lumber market quite closely and any pulp exports again, it's difficult to know exactly the volumes that come out of Russia, but again, the FSC accreditation may apply to lumber and of course, that has an impact into some of the products that we use, such as wooden pallets. Again, it all depends, on the market who is FSC accredited, who isn't, are the suppliers coming accredited or not, but clearly thinking not so much in craft, but in some other areas, it might be a little bit tighter. When we look at the whole inventory chain in Europe, as I'm sure you've seen it has been increasing the amount of stock of OCC, but also of paper, test and craft. The most recent figures show up about 900,000 tonnes, and it's back to my original earlier comment that we don't see any sort of issue about security of supply, but there are a number of suppliers who have stopped producing. I'm not sure it's about their cost position. I think it's more about their hedging position to be quite honest with you. Such has been the increase in energy costs, so frankly a little bit more efficient on your production. I don't think it makes an awful lot of difference compared to the increase in the cost of energy, but the inventory supply chain looks fine. We don't have any particular issues there. When we look at the import and export, you're absolutely right that the U.S. has been exporting a little bit more. There is a bit more capacity that's come on in the U.S. Some of that's finding its way into Europe. Again, it puts into perspective the issue about the potential reduction in the export of craft from Russia in terms of the availability in the U.S. with some of the new capacity, but there has been a little bit more. I think in the export market for a test liner that has been a little bit more buoyant recently. With what's happening with the supply sector in Europe, that's something that might reduce in the near term if there are any effects of lower production of test liner in Europe. So, that is that sort of buffer because obviously it's much more profitable to sell it in in Europe, particularly and look, it's very hard to tell, but with the announcements, I'll be very, very surprised if there wasn't another paper price increase. So, in summary, with that increase, we don't see Russia having particular effect on Kraftliner. The U.S. is exporting a bit more. We've got the export buffer as well for Europe. So, at the moment it seems fine. It seems fine to us, but let's see what the coming months bring us, but certainly seems fine at the moment. Thank you.

Operator: Next question comes from the line of Kevin Fogarty from Numis. Please go ahead.

Kevin Fogarty: Oh, thank you. Good morning, everyone. Just two for me, if you could do please, just number one, in terms of what you said about pricing and cost dynamics, I just wondered if you're sort of confident on delivering H2 profitability kind of in line with your medium term targets and just secondly, could you just help us understand the level of hedging, particularly for energy going into FY23 at the moment, please?

Miles Roberts: So, I could just take the pricing agent if you want to talk about the hedging. So, just on our pricing, we showed at the half year that our level of price increase had absolutely matched the level of cost increases in that period and that trend is more continuing in the second half of this year. So, although costs have gone up considerably, our pricing has gone up considerably and we do expect that to continue over the coming months and into next year, basically recovering that very early part of the LAG in the previous financial year and with all of that, with good volume, our outlook for H2 is unchanged from the guidance we've given previously despite all of these changes and that is for a very significant increase in profitability in the second half, over the first half, over the second half of this year and over the first half of last year, that all looks to be absolutely all fully in line with our expectations.

Adrian Marsh: So on hedging, we run a three-year program. There's two months of this year to go. We're fully hedged for this year and into next year as you would expect, we're substantially hedged for next year now. So, very high levels and pretty well placed for the following year, so it's what we do. We've done it in my time, so we've always had a program. So, at this point of the year where we're looking at budgets for next year, we don't have a significant energy exposure at all.

Operator: The next question comes from the line of Justin Jordan from BNP Paribas Exane. Please go ahead.

Justin Jordan: Thank you. Good morning, everyone. I've got three quick questions, if I may. Firstly, on volumes, you've previously given us a number of 9.4% for volumes in the first six months to October 2021 and you're now talking about mid-single digit like volumes for the year to 2022. So that's clearly a distinct slowdown in growth in Q3, Q4. So, can you just give us some colour on what current volumes are firstly? Secondly, I appreciate if this is a really difficult question, but as you see clearly a more challenging and more uncertain geopolitical and macro outlook, what is the potential impact you may see on consumer spending and box demand from that and thirdly, clearly thank you for the colour and the reassurance on energy hedging, can you just remind us what you're seeing on terms of other costs? I'm thinking in terms of cost inflation and transport and other raw materials such as chemical and starch and the impact that may have on the group? Thank you.

Miles Roberts: No, thank you. So, in terms of the volume, we're getting good growth in the second half over the second half of last year and as you know, in terms of the second half of the previous year, the comparator was a much, much stronger figure. It was over 8% and so the same in terms of the actual sort of growth in volumes, that is continuing to be – it's a very good performance. It's just when you start to compare it to first half or second half, with those comparatives, which swung quite wildly last year, you get these differences, but as we had the capital markets over the evening a few weeks ago and we talked about our medium term growth in the future being higher than it has been previous to COVID and we

continue to see that trend. So, we do think that we won't be at the 9.4% for the full year, but we will be showing a very good level of growth over last year, which itself was a good level of overall growth, but you're right, in terms of the consumer spending. Clearly with energy cost, etcetera, and the cost of living, that's clearly going to put some pressure on household incomes and look, none of us know exactly what's going to happen, but I do think some areas have more discretionary consumer expenditure. I won’t be surprised if they followed the same paths as they followed in similar situations in the past and there is a decline in consumer discretionary expenditure, and that's why we put what 85% of our business behind the FMCG and very resilient sectors and I would just remind everybody we have never seen a reduction in volume in those sectors since our records began, and that's been through some very challenging economic periods. If we look at COVID when GDP was down significantly across Europe, our volumes went up 3½%. So, clearly it's going to have an effect, but we feel in terms of for ourselves where you position the company, we do expect to see some on-going volume growth because of that focus. And as you say, Justin, in terms of other costs, they have gone up considerably. Starch is a significant cost for us, but as you'd expect, we've got a substantial hedging program there as well. So, we have protected ourselves for this year and well into year. So, again, we can see some of the knock on effects off this current sort of crisis and we've taken action, I'll say, quite some time ago to protect ourselves, but we are, I think we will see all these costs come through in pricing, and we remain very successful at getting the price increases that we need not only for energy, but for starch and you're absolutely right on transport as well. Again, there we have a hedging program, as you would imagine on fuels, but all this has historically given us sort of 5% price increases per quarter and if anything that looks like it's going to move upwards over the coming months to fully recover these costs, but thank you.

Operator: The next question comes from the line of David O'Brien from Goodbody. Please go ahead.

David O’Brien: Good morning, gents. Thanks for taking my questions. Back in December, you indicated that 50% is new capacity in Poland and the Italian corrugated facilities have been committed to customers. Can you just give us an update on if those facilities are on course to open in Q4, what the percentage of capacity commitment is now and is that in your like for like assumption for the year, is the first question? And secondly, you've pointed out in the statement, balance sheet leverage is going to reduce again by the time we get to year end. How should we think about your appetite for capital deployment with that in mind, given you’ll be under your own comfort levels? And then finally, again, in the statement, you've noted the momentum behind the sustainable solutions is strong. Are you still seeing the pace of conversion to more sustainable products accelerate and is there anything else of note you'd like to share with us in terms of pricing or contract duration versus more traditional solutions?

Miles Roberts: I'll take the first and the last and Adrian if you are feeling the balance sheet. In terms of the new facilities in Poland and Italy, the Italian is just starting production now, but given we've got only a number of weeks until the year end, it won't have any material effect in our like for likes for this year. We said it's 50%. It is now significantly more than the 50% pre-sold. We had an expectation of how it will be filled, but that expectation has been significantly surpassed. It's been really, really well received by our customers in that region. In terms of the Polish facility that will also be completed by the end of Q4 and

similarly to the Italian; it is now significantly more pre-sold than it was at the half year. Again, it's ahead of our expectation and I have to say with the current sort of crisis there, demand for our product in that region has only accelerated. These aren't huge moves, but it is very encouraging. It's interesting your third question about sustainable solutions. These are long term trends with our customers and clearly there's an energy or cost of living crisis, etcetera, in the consumer, but we are seeing on-going strong demand for these products. If we look at the Italian and the Polish, those new facilities, it's predominantly the way the product is produced and the sort of products are very much in line with our more sustainable solutions. We have seen generally the supply contracts being longer. That's been a trend for a while now and that continues. Interesting with, I think some of these issues at the moment in the market and people being sort of unsure about supply chains. If anything, we're seeing customers who can come to an end of a contract just wanting to roll the contract forward without going out to the market, etcetera. At the moment, this is a very dynamic market, but if anything, that's what we're seeing, but our pricing, as I said in our expectations, for this year, we aren't changing anything and therefore our pricing is going well and back to our service quality, the balance sheet is going very well.

Adrian Marsh: Yeah. David thanks. In terms of the balance sheet, we're obviously very thoughtful about it as you would imagine. We set our targets. We've gone on a deleveraging path, as we've described on a few occasions now. Unlike others, we haven't announced huge capital program, so we remain very flexible. We're looking at where the opportunities will be for growth and we're very much able to keep our powder dry at this stage, but it remains a constant care for us at the moment is looking to manage cash as effectively as we can to deleverage and give us the optionality and the flexibility.

David O'Brien: Thank you. Thank you very much.

Operator: The next question comes from the line of Brian Morgan from Morgan Stanley. Please go ahead.

Brian Morgan: Hi, guys, thanks very much for the time. Can I just go back to the hedging questions? You've told us that starch is hedged, transport is hedged, obviously, energy is hedged. What else is hedged in your cost base and in fact, what percentage of your cost base is hedged and then is it possible to hedge OCC? And then if you could just chat a little bit about energy in particular? Obviously we know that you've hedged, but we don't know at what point in the curve you've hedged and the timing thereof, etcetera. So, just give us an idea of what kind of cost inflation to look out for in terms of energy cost.

Miles Roberts: Just in terms of our hedging, we price at the market price for these products. What our hedging position is, frankly, it's an internal issue. Just so we're clear, we are hedging things like starch. We hedge the fuel on transport where we can. It's not completely hedged, but we do have a hedging program there. OCC, there isn't a way of hedging that, although we do have, as you know, we're sort of a, so leading recycler of fiber and that gives us the security of supply, but it also gives us some benefits in terms of the price of OCC. It just gives us a little bit of coverage there and in terms of things like energy, it is a very dynamic program, but constantly looking at the markets, constantly looking at where we think it's going and what's our hedging position and we're giving the position as we are today. In three months' time, it would be different again, in two months' time, it would be different.

We're constantly looking at this and moving our positions in a sort of a very, it's a dynamic hedging policy.

Adrian Marsh: Yeah. Effectively, we talked a few months ago that we'd expect to be flat year on year on energy next year to this year. Looking at it now, I'd expect it to be a very small increase year on year as it stands, but significantly, the cost is going to be consistent with this year.

Miles Roberts: Thank you.

Brian Morgan: Thank you.

Operator: Next question comes from the line of Sam Bland from J.P. Morgan. Please go ahead.

Sam Bland: Yeah, thanks for taking the question. I suppose you're following on from the energy point. I guess you seem to have more hedging than most or all other operators. I would have thought that that's going to give you a competitive advantage over the next few months and quarters. I guess first point is sort of, do you agree with that? And the second question is, how do you think that competitive advantage will show up in your results? Is it that you can put prices up in line with everybody else but don't have the same level of cost increase? Thank you.

Miles Roberts: We don't know what other people have hedged, what they have and what they haven't. We don't know the pricing if they have and what they haven't. You can be absolutely sure that we'll be charging the price for our product we feel that is very competitive. As you said, we are expecting to achieve a substantial improvement in profitability in the second half of this year, over the first half of this year, over the second half of last year and you can see the market forecast for next year as well and that was again, the company continues to grow its profitability despite some real macro headwinds. I think the thing for our customers is are we giving the service, the quality, the innovation, that security of supply and we've absolutely shown them how we can do that over a pull back at something extraordinary. Let's just say, some very challenging times and they continue to reward us with increasing market share and increasing added value.

Adrian Marsh: And I think having a short paper strategy certainly gives us the flexibility going forward at the moment.

Miles Roberts: Absolutely. That flexibility and that exposure to all those, so many issues in the paper industry so no, we're pleased with that, but thank you.

Operator: The next question comes from the line of Sean Ungerer of Chronux. Please go ahead.

Sean Ungerer: Good morning, Miles and Adrian, thanks for the update. Just in terms of your comments around containerboard availability, obviously that's pretty sufficient at this time. I'd just have to see how you sort of team up with high supply, demand dynamics for the rest of the year on the containerboard side and then linking to that, obviously the comments around not surprised to see further price increases, but it sounded like there's more cost push as opposed to sort of any supply, demand and then on my last question, since the OCC prices, outside of a collapse in testliner demand, what other sort of drivers could see OCC price or weakness come through? Thanks.

Miles Roberts: On the availability, industry stock on containerboard. Industry stocks got quite a good level. If we look at ourselves, obviously we have some of our own production and we have the ability to flex that production and indeed we sell a lot of that production externally and again we can choose to integrate that if we need to, but we do have long term supply agreements with our paper suppliers. It gives us tremendous flexibility and those have worked and continue to work very well for us and we aren't seeing any of our suppliers saying that they won't be supplying us, going against the contracts that are in place, but I do think the squeeze on the paper industry, I wouldn't be surprised if there was another paper price increase and to recover all these costs that they're incurring. I'm not sure it's going to be an increase in the profitability, but just to incur the cost and obviously in our position, a lot of those costs stay with our supply chain until they come through in paper and then we pass them on. So it gives us that bit of insulation that our paper supply strategy has. With OCC, export demand for OCC is quite strong at the moment, and it's partly, we think, due to the U.S. In the U.S. there are a lot of the ports are blocked. They are not exporting the OCC, they have in the past. So, OCC prices in Europe have stayed high and in fact very recently have started to increase, particularly in the export markets such as the UK. So, again, it's another cost push on paper, and it's another reason why we think paper prices are likely to rise in the future, but obviously we don't know, but we would not be surprised at all if we saw those costs push come through in paper. I'm not sure it's going to be sort of a huge demand pull. It's much more of a cost push as a paper industry really has to try to recover these costs to – yeah, they just have to recover these costs, no, but thank you. Thank you for the question.

Operator: The next question comes from line of James Twyman of Prescient. Please go ahead.

James Twyman: Yes. Thank you very much for taking the question and apologies if this has been asked, but you did announce a containerboard price increase a month ago. I didn't see whether any other companies followed that, it'd be great to know if they did. Did you have any success with that and if not, are you continuing with that price increase? I know you've mentioned about the future, but so just in terms of where we stand now, that would be very helpful. Thanks.

Miles Roberts: No, you're absolutely right, we did. We could see what's happening with energy and OCC, so we did announce an increase. The industry indices did not reflect the increase that we put down for March deliveries. It's just interesting to note the recent flurry of announcements from other paper producers about having to increase. We saw one yesterday for €125 a tonne on the market and as I said, I would not be surprised if that was – our only surprise was the indices didn't reflect our increase in February, but such is that paper market, but look, I'm conscious of everybody's time, I'd just like to say thank you to everybody for your attention and also your questions today just to really say we've outlined our exposure to the Russian market, which is minuscule. We've got a lot of cost inflation coming through, but we are successfully recovering. Our volumes are going up and we're on track for the full year but thank you very much for your time today. Thank you.

Operator: Thank you for joining today's call. You may now disconnect.