DS Smith Plc – Spicers Offer Received Conference Call
6 July 2011
8:00am Greenwich Mean Time

Operator: *Welcome to the DS Smith Conference Call. At this time, all participants are in a listen-only mode. Later, we will conduct a question-and-answer session. Please note that this conference is being recorded.*

I will now turn the call over to your host, Miles Roberts. Sir, you may begin.

Miles Roberts: Good morning, everybody, and thank you for joining us today. I'm Miles Roberts, the CEO of DS Smith; and I'm here with Steve Dryden, our CFO.

As you will have seen from our release this morning, we're very pleased to announce we have received a binding offer for Spices, our European office products wholesaling business. The offer is from Unipapel for an enterprise value of £200 million. The disposal of Spices is a key milestone in the transformation of a company which was launched over the last year and it goes to the heart of our strategy to become the leading supplier of recycled packaging for consumer goods. In our strategy review, we announced we wanted to create a business that was more focused, to be able to deploy capital to parts of the business where you have a strategic objective, and this is a fundamental part of that.

Turning to the first slide on the analyst presentation, the offer received for Spicers, non-core business, of £200 million represents a 6.9 times EBITDA multiple on the 2010/11 result. It will reduce the Group's cost of capital from about 11% to around 10.5% pre tax, and it's our clear intention to reinvest the proceeds strategically to develop the recycled packaging business for consumer goods and to demonstrate to our shareholders the capital discipline that's being put in throughout the Company.

Slide three. We're delivering on our stated aims regarding Spicers. The first was to improve the management. We have strengthened the management team over the last year with – partly with the appointment of a new chief executive. We said we'll improve the profitability of Spicers, margin discipline, cost management, service management results in the profits of 2010/11 increasing by 18% on the prior year, and delivering value to shareholders, maximising value to shareholders at 6.9 times EBITDA multiple for the £200 million enterprise value.

Transaction terms on slide four. This is all subject to the Works Council consultation as well as anti-trust clearance. The Works Council is a standard part of any M&A activity in continental Europe. It's the same as Otor, we had to go through Otor, the acquisition we made last year. We understand the process very well and we'll be consulting with all of our Works Councils on the continent over the coming months. There's a long-stop date at the end of December 2011, but I will also be aiming to complete this considerably more quickly. And in terms of the pension fund, as you know, we closed the pension fund last year and therefore the Section 75 liability no longer applies. But in recognition of this disposal, we have agreed with the pension trustees that we'll make an accelerated payment into the pension fund of £15 million this year. This is a payment which would have been made in any case over – in later years, but we just brought it forward into this year.

Slide five, pro forma for DS Smith ex-Spicers. Well in 2010/11, our turnover was £2.474 billion and an EBITA of £136.1 million; and following the disposal of Spicers on last year's results, our revenue fall to £1.759 billion and an EBITDA of £110.9 million. The dividend cover on 2010 is well within our target range.

But importantly, how have we looked at our medium-term strategic financial targets? Well on volume growth, we said we will be growing ahead of GDP and ahead of the market for recycled packaging. That means above 3% volume growth per annum. Our EBITDA margin with Spicers was 6 to 8%, but we now revised net upwards to 7 to 9%. Our return on average capital employed, not forgetting that Spicers had an above average return on capital employed for us, but we have maintained the target of between 12 and 15%, showing our confidence in the recycled packaging business. Operating cash flow before growth capex to operating profit, a cash conversion of at least 120% and keeping our balance sheet nice and tight with net debt to EBITDA below two times.

But how do we see those proceeds being used? We outlined in our recent full year announcement, we hope to invest to expand our footprint in Europe. We have two excellent positions in the UK and France. Our customers want to see our innovation being rolled out more uniformly across Europe. The business is fragmented and we see plenty of opportunities to grow behind what is a growing market in recycled packaging.

And on slide eight, we show the amount of fragmentation in the marketplace. And again, for our customers and shareholders, we feel that consolidation of this market will be very attractive.

So slide nine is a summary. We're progressing with realigning our business mix, exactly as we've said that we would do last December. I hope it represents to everybody the disciplined way in which we allocate, a fundamental part of any business model and we'll seek opportunities to reinvest, but only where we see the right business model and the right returns to shareholders.

Thank you, everybody, for your time, and happy to take questions.

Operator: *Thank you. We will now begin the question-and-answer session. If you have a question, please press star then one on your touchtone phone. If you wish to be removed from the queue, please press the hash key or the pound sign. If you are using a speakerphone, you may need to pick up the handset first before pressing the numbers. Once again, if you have a question, please press star then one on your touchtone phone.*

Harry Philips from Evolution is online with a question.

Harry Philips: Good morning, everyone. A couple of questions please. **Just thinking of a timetable for reinvestments, at what point do you have to wait for the proceeds then to reinvest given you're talking about a possibility of a conclusion at the end of December or would you put some debt on the**

balance sheet temporarily ahead of that expected sort of income to cash? The second question is: Plastics sort of gets increasingly less mentioned as a potential source of acquisitions, so should we assume given the charts you had in today's presentation and in the – obviously the presentation a couple of weeks ago that that map and the sort of clear indicates on there is very much the focus of attention? And again, I suppose just finally would £400 million be the sort of ideal size you would like to do?

Miles Roberts: Thanks, Harry. I think we'll – I'll cut these questions up, Steve to answer your first and third question, then I'll come back to talk about plastics and how we see that business.

Harry Philips: Okay, thank you.

Steve Dryden: Okay. Harry, Steve here. Obviously, we just published our results last week so you can see the strength of the year end margin and the cash generation, so on that basis, I don't feel constrained in terms of some of the acquisition opportunities we're looking at that I have to wait until the actual transaction completes before we can – before we reinvest.

In terms of absolute turnover, I think we've demonstrated in terms of the acquisition of Otor an excellent track record to buy well, integrate well, and deliver good returns, so I hope that people will give us 12 to 18 months in terms of a reinvestment window. The key thing people should understand is how disciplined we are towards that cost of capital. Our cost of capital falls about 10.5% because we're far more the recycled corrugated business where we set our targets and we've maintained our targets in the 12 to 15% return on capital, so we're very disciplined and we won't invest and spend money unless we can see clearly how we're going to achieve those returns.

On the £400 million, it's actually a function frankly of you can see we have that capacity today plus the potential proceeds from Spicers, but equally you need to remember in terms of, ...we were always buying cash generative stable margin businesses and as such there's a leverage and effect from there on the EBITDA. So you're right, £400 million, it also just depends to some extent the scale of the opportunities that we execute on.

Harry Philips: **But in sort of broad generalities that's the sort of scale?**

Steve Dryden: Yeah, if you were looking to build a model on spend ex at this time to EBITDA, this sort of financing cost, yeah, that's a fair position to adopt.

Harry Philips: Great. Thank you very much.

Miles Roberts: Plastics, the main part of plastics, not all of it but by far the main part, is where we make the plastic bags that go inside corrugated boxes for transportation of liquids. It's the part of a business that it's a growth opportunity for corrugated that I think is really very significant. Corrugated is for various reasons used more in the packaging of dry products, particularly in consumer goods, and I just feel that the opportunities that corrugated presents for transportation of liquids because of its recycled nature, because of the way you can basically make it into a cube and therefore reduce transportation costs was mostly bottles or plastic bottles, glass bottles, et cetera. I just think it's going to have a longer-term real growth opportunity for us. So, yes, we do see there are some small bolt-ons, but we don't think it's going to be a major thrust for us in terms of acquisition activity in plastics simply because it actually got very good business today and it's much more about making the best of that rather than acquiring somebody else. So nice business, but I think the best format is I think we'll see it over the next few years, just really thinking about the next three or four years is where I see the opportunity.

Harry Philips: Great. Many thanks.

Operator: *Ross Gilardi from Merrill Lynch is online with a question.*

Ross Gilardi: Good morning, guys. I just had a few questions. **First on the – could you give us a sense of what the net proceeds might look like? The £200 million was an enterprise value and I imagine you have a little bit of tax costs, transaction costs, and you mentioned bringing forward the pension payments. How much cash do you think you'll bring home assuming this deal closes?**

Miles Roberts: Okay, I'll ask that Steve to take you through that.

Steve Dryden: Yeah, I think when all the tax is paid, the accelerated pension payment, et cetera, I'd expect to see about £160 million, plus these things are never precise but – because we obviously got to get the completion of EWC process, et cetera. But in terms of your modelling, that's what you'd use.

Ross Gilardi: **And in terms of reinvesting the proceeds, do you think you're able to redeploy in such a way that you're able to offset any earnings dilution that might arise in say fiscal 2013?**

Steve Dryden: Yeah actually I do in terms of I think the acquisition pipeline that we got out there, do I believe that there's sufficient high quality businesses that we can drive value in terms of cost synergies, procurement, some of the commercial synergies to offset the dilution, yes, I do believe there's opportunity there. But you go to be really clear, Ross, is we won't just go spend a huge price and kill the return on capital just to cover earnings dilution.

Ross Gilardi: Right.

Steve Dryden: Those targets that we put out there are there for a reason, so we're quite focused on our positive return on capital. But you can see, we actually pulled out a slide from our results' presentation the previous week just so to remind people just how fragmented the European market is for recycled corrugated packaging.

Ross Gilardi: **And just given that, what type of multiple? Could you give some type of sense as to what type of multiples you'd expect to pay for businesses that fit your criteria? You sound very clear that you're not interested in buying broken businesses that need to be turned around. It sounds like you want to buy things that are very similar to Otor that are innovative and that have got a track record and a strong customer base and so forth. So if you could**

provide a little colour on that and whether or not you would expect anything you acquire that it would meet sort of your 7 to 9% margin criteria – or targets for your base business up front.

Steve Dryden: The problem is you've got to judge each acquisition on its investment case at the time and as a function of how much of the synergies can you add and how quickly. As you know from the Otor, we saw – we delivered on the cost and procurement savings very quickly. The commercial synergies, as you'd expect, take a little bit longer, probably they're harder to count, but they are there. But we've always built an investment case based on the cost synergies. The issue to us if I can't give a number now, every person I go talk to will give his advice and pretty quickly quote back to me what he said he will pay X, so we're not prepared to do that. But people could see in terms of Otor of what a high quality recycled packaging business focus at FMCG with very stable earnings and margin profile and people can see the model we paid there. I don't really want to get into the DS Smith pays X. I just don't think that's a sensible position for us to be in.

Ross Gilardi: Right. Fair point. Okay, guys, thanks very much. Best of luck.

Miles Roberts: Thank you.

Operator: Myles Allsop from UBS London is online with a question.

Myles Allsop: Yeah, just a couple of quick questions. **Just in terms of the earnings impact, excluding any acquisitions, which will hopefully be accretive, is it right you think it's going to be about 10 to 15% dilutive in the first instance?**

Steve Dryden: Yeah, that's correct.

Myles Allsop: Okay. **And could you give us – just with Unipapel, I mean obviously there's this breakup fee that you pay if you walk away from it, how binding is this and is there any way that they can wiggle out of it?**

Steve Dryden: Surely hope not. Myles, if I felt that they can wiggle out of it, using the words "wiggle out" as your objective, clearly I wouldn't have entered into – we wouldn't have entered into discussions frankly with them. The key thing is this is absolutely subject to a Works Council approval process, which is why we've entered into a binding offer and we expect to consult with the Works Councils across Europe and then we can look at just the outcome of that as the best way to proceed. But you need to understand, we've done this before. We've been very clear as to how we executed on the Otor transaction. We're very comfortable with this process. We actually think that Unipapel is a great home for the Spicers' business across Europe and that they'll be able to develop in the future, so I think it's a very positive message for the employees and our customers.

Miles Roberts: Just picking up Myles on the break fee, actually we choose to sell it to somebody else because there's obviously quite a timely lapse between the announcement and completion. We said there's a backstop date at the end of December, but obviously we hope that it's concluded much more quickly. But this is about saying, but if you sell it to somebody else, it's our decision that we decide to sell it, then there's a break fee of just over £11 million, but obviously that's our decision to do that. And although we take that position, we felt that was in the best interest of our shareholders, but obviously we don't think that's likely.

Myles Allsop: And the...

Miles Roberts: ...discretion.

Myles Allsop: **There's no break fee the other way around if they walk away?**

Miles Roberts: Oh, they are bound.

Myles Allsop: They're bound to pay.

Miles Roberts: We can sue them.

Myles Allsop: Okay.

Miles Roberts: Is that binding contract from them that we have not entered – entered into a binding contract with them because we can't by European law with the Works Council. They can't get out, but effectively we can.

Myles Allsop: Okay, that's helpful. **How long did the Works Council approval take with Otor?**

Miles Roberts: That was very quick. It was…

Steve Dryden: About seven weeks.

Miles Roberts: Yeah, very, very fast. We're dealing with… But that was one country. The two businesses, as you can see from the result, we have an outstanding acquisition. We knew the culture. We knew it went well and let's see where we get to with this process, but it took, yeah, two months before. And then you've got the anti-trust which takes up to 60 days.

Myles Allsop: Okay. **So kind of six months kind of anti... The deadline is quite conservative in that respect?**

Steve Dryden: Yeah but, Myles, you'd expect us. You know us. You'd expect us to be talking about that...

Myles Allsop: Yeah.

Steve Dryden: …because you go into proper consultation with the employees.

Myles Allsop: Yeah. **And then sort of going on to kind of what acquisition opportunities and you're kind of saying sort of deliver the right returns to shareholders, is it right that we should be thinking that you'd be looking at 12 to 15% range and that is the kind of key financial criteria when it comes to acquisitions?**

Steve Dryden: Yeah, I think we've put out there, Myles, is the return on sales and it's that consistent delivery of margin and obviously the discipline and return on capital.

Myles Allsop: Okay. **And just lastly as well on the Ukraine associate, is there any update there? I mean I guess it is on the agenda as well on the balance sheet again.**

Steve Dryden: That's an actually fair point. Unfortunately I've been a little bit busy last week, but I certainly am now going to focus our attention on it a little bit more, but we are **–** we feel that we've got a good relationship with the banks and we are close as just... It's quite a very detailed process that we just have to work through with a number of banks as well as Ukraine, so we'll update you on that, but we'll certainly be turning our attention to that in the near future.

Miles Roberts: As soon as it's done, there'll be an announcement.

Myles Allsop: Okay.

Miles Roberts: But thank you for raising it because ...

Myles Allsop: Okay, keep us on our toes. Thank you.

Operator: Mike Murphy from Numis Securities is online with a question.

Mike Murphy: Yeah, good morning, guys. Just a couple of questions please. **First of all, is that balance sheet at the end of April representative of the normal trading conditions of Spicers?**

Steve Dryden: If you look at the balance sheet, Mike, the £108.5…

Mike Murphy: Yeah, sorry, Steve.

Steve Dryden: ...average employed something like 118, so there may be pretty much close to represent them the whole year.

Mike Murphy: Okay, and just following on from that. **Your target on working capital savings you talked about at the time of the analyst meeting, you targeting £75 million by April 2014. Will that change at all?**

Steve Dryden: We'll have to go through and review that one, Mike, but at the end of the day I'd say we've got £200 million of stock. There's a lot to go out there. We made some good progress, as you'll recall from that the other week. There's a lot of other opportunities to chase after.

Mike Murphy: Okay. **And, just to be sort of clear on the net proceeds, it's £200 million gross and pension 15 and then taxes and fees et cetera.**

Steve Dryden: Fees, yeah. Obviously there's working capital adjustments, et cetera, Mike, and completion accounts. I guess that's why we say approximately.

Mike Murphy: About £160 million, okay. And then sorry the final, final question. **How long have you been talking to Unipapel on this?**

Miles Roberts: We announced… We said what we're going to do in December, non-core businesses...

Mike Murphy: And they run…

Miles Roberts: …is December, November/December.

Steve Dryden: Well we asked them to tell us, give us an idea of value effectively we can make a decision in terms of how much of the business realised versus how much do we think we can continue to drive the profits forward, and they gave us an estimate. We actually as a result of the December process, we received a lot of proactive approaches from other parties. You don't know the value until you get to – you run to and you start talking specifically to one or two people.

Mike Murphy: **Yes, I mean it seemed pretty obvious from the strategic review of last year that Spicers was non-core most investment bankers should be knocking on your door and companies would've been knocking on it. So what I'm trying to get at is probably actually the sale process is almost done. It's unlikely that someone will come in and trump the offer.**

Steve Dryden: Well who knows, Mike? I think we found someone who can take the Spicers' business and they can develop it across Europe and strengthen it rather than just trying to decide will anyone else come on.

Mike Murphy: **Yeah, I mean I don't know Unipapel, but I mean presumably they do have the cash resources. They don't need to get for funding elsewhere. That's all in place.**

Steve Dryden: We wouldn't have entered into this otherwise.

Mike Murphy: Yeah, I just wanted to clear that. All right, that's great. Thanks, guys.

Miles Roberts: Thank you.

Operator: *Donal O'Neill from Goodbody's is online with a question.*

Donal O'Neill: Hi, guys. Good morning. Just a couple of quick ones from me. **First one in relation to operating margin, you've upped your target from 6 to 8 to 7 to 9%. Firstly, given the sort of margins that we know Otor produces and maybe in line with your strategy for acquisitions, is it conceivable that in the longer-term that sort of margin range might move bump up to 8 to 10%?**

Miles Roberts: The best parts of our business, companies like Otor, we're saying we can make with our synergies in excess of 10% return on sales. We've given targets specifically because we still have some paper in our portfolio. We have a big mill in the U.K. That is more cyclical, and that does have an effect. So the very best of our business is delivering the 10% plus, but there's a little bit of a mix in there. I think what's important is when we say things to shareholders, when we talk about forecast and our ambitions, that investors understand and they're believable, they're achievable. We can always upgrade in the future depending on performance, but at the moment we're saying we've got a good range here. There's still a mix of business and each month we still have more work to do to get into. But as you say, the very best of our business does perform ahead of that.

Donal O'Neill: Okay great. Thanks, Miles. **And secondly just in terms of reinvestment, is the pure focus of reinvestment in terms of what the other facilities available, is to acquire or invest in existing business? Would you at all look at dividend payments or extra dividend payments?**

Miles Roberts: We're here to maximise returns for our shareholders. That's our job, and we will invest in Greenfield acquisitions if we can make value and enhance the investment. Capital enhancing, it's a return on capital issue for us. If we can't, then the money's going to go back to shareholders. We want an efficient balance sheet, but I'll stress I do think that are a number of opportunities. We're not going to rush in there. We hope people see we're disciplined. But if we can't, then the money will go back to shareholders. There's absolutely no question about it.

Donal O'Neill: Okay, that's great. Thanks, guys.

Operator: *As a reminder, if you have a question, please press star then one on your touchtone phone. We have no further questions at this time.*

Miles Roberts: Okay. Well thank you very much, everybody, for your time. As always, we really appreciate your interest and the time you spend on us and hopefully we'll talk again soon. Thank you.

Operator: *Thank you, ladies and gentleman. This concludes today's conference. Thank you for participating. You may now disconnect.*