DS Smith Q1 Interim Management Statement
DS Smith Plc
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Operator: *Welcome to the DS Smith Interim Management Statement 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 this morning. I'm Miles Roberts, the CEO of DS Smith, and I'm joined with Steve Dryden, our Group Finance Director.

So this morning, ahead of our AGM, we're pleased to release our Q1 Interim Management Statement. I would like to take a few minutes to run through the highlights of that statement, after which Steve and I will be delighted to take any questions you have.

But before getting into the detail, just by way of overview, I'd like to say that we're pleased with the performance of DS Smith through Q1, both with regards to growth and also progress that we continue to make towards our financial target and strategic goals. So in terms of trading and looking at the Group as a whole, with trading being good with like-for-like volumes in corrugated packaging up 3%. This is fully in line with our expectations and the target, but reflects the resilience of our fast-moving consumer goods customer base. FMCG customers account for about 75% of our UK box sales and about 65% in Europe. We have also continued to make progress on the Group return on sales margins, and conversion of profit into operational cash flow has been robust with absolute working capital improvements continuing despite both the acquisition of Otor and the increase in raw material costs.

So running through some of the highlights from the Packaging business. As I said, we've seen a strong revenue growth of 13%, reflecting underlying volume growth and the recovery of substantial cost increases, and we remain focused on completing the process of recovering these costs by seeking to differentiate DS Smith through high standard of service, quality, and innovation that we offer.

Trading in the period benefits from the inclusion of DS Smith Packaging France, which is performing very well both in terms of revenue growth and progressive delivery of the previously announced cost synergies of €13 million, and we also continue to make good progress on the previously announced procurement and UK efficiency savings. These programmes are on track to deliver the expected £6 million in total in 2011/12.

And in relation to Spicers, our office product wholesaling business that we received an offer for that was announced in July, we're also making good progress. We're working through the legal process of employee consultation, et cetera, which is all going fully according to plan.

And finally, and very importantly, with regard to the outlook, we remain confident in the strength of the refocused DS Smith business model with long positions in recycled corrugated packaging and in the collection of fibre with a more limited and, as a previously announced, reduced exposure to paper manufacturing. Our focus on FMCG customers is an important part of our strategy as the resilient demand for consumer goods reduces the volatility in the demand for our products.

So despite the ongoing challenging macro-economic environment and the recent turmoil in global markets, we remain confident in the trading outlook for the year. The Group will continue to make further progress towards the previously announced medium-term financial objectives in this financial year in terms of margin improvement, return on capital, and cash generation.

Now Steve and I will be very welcome to answer any questions you have. Thank you.

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.*

Myles Allsop from UBS is online with a question.

Myles Allsop: Hi. Yes, just a few quick questions. **Firstly on the volume side, you've seen some 3% volume growth since the beginning of May. Have you seen any signs of volume slowing? I mean when you look at the world around us, you'd expect there to be some signs, particularly on the industrial side maybe more than the FMCG side. But are there any kind of warning signs out there in terms of corrugated volumes?**

Miles Roberts: We're just at 3%. During the period, there's obviously four months in there and we got to the end of August and we haven't seen any decline in that like-for-like sales growth, which is obviously against quite a strong comparator to last year. When we go into the segmentation, we do see FMCG is very resilient, and that 3% is a net figure. Now some parts of the industrial sector where we do have exposure have -- it has certainly been more mixed. But such as our growth in FMCG, it's more than offset that. So in answer to your question, overall we're seeing our like-for-like continuing well. There are differences. Some industrial sectors are suffering, but our FMCG just keeps on coming through because people do not stop eating and drinking.

Myles Allsop: Okay. **And then in terms of sort of testliner prices, I mean the sort of list prices came off a bit over the summer, what's your expectation there? Do you think that's stabilised? Is it underpinned by waste paper? What's happening to testliner inventories when you look at the broader European market today? Are they creeping up in a worrying way?**

Miles Roberts: I mean as I said, we're becoming very short in paper. And as it stands for paper increases that we've been recovering. As I always say, I am much more concerned about how we recover, how we price for value added frankly rather than the cost of our raw materials. And if you look at paper in particular, I think over the last few months, the price certainly isn't increasing as it has been. The cost of fibre remains high. Various energy costs remain high. So frankly, who knows what's going to happen over the coming months, but it's just one of our input costs.

Would you add anything to that, Steve?

Steve Dryden: No, I think the key to me is that a substantial cost that underpinned year-on-year increases in paper was the fibre costs and the energy prices and actually I guess we worry less about trying to predict what happens on input costs and more about making sure we recover whatever those cost increases may be to our customers.

Myles Allsop: So I mean overall, you're not too concerned about testliner prices. **What about inventories, have they crept up over the summer in a meaningful way?**

Miles Roberts: Well in terms of the industry stocks of testliner?

Myles Allsop: Exactly, yeah.

Miles Roberts: Well look, we understand that they have increased. We obviously look at that to make sure we can procure paper at the best price and they understand that some stocks have increased. It is the summer and there's always a bit of volatility in the summer. You're never quite sure about holiday seasons, bank holidays, et cetera. But overall, the level of stock has -- in paper has risen, but who knows what's going to happen over the next few months.

Miles Allsop: **In absolute terms, where is it today relative to where it's been in the past? Is it at a worryingly high level or just a seasonally normal level?**

Miles Roberts: Right. If you look at the stocks, they are higher than they were at this time last year, but they remain way below where they reached a few years ago, so it's staying sort of -- in sort of average. If you look over the last five years, testliner stocks are probably slightly below the average, but they have increased over the last couple months.

Myles Allsop: Okay. Maybe one last question as well. **I mean on your business development and sort of further acquisitions, I mean can you… And obviously you've got a strong balance sheet after selling Spicers, particularly strong. I mean how quickly are you looking to spend that money? I mean how disciplined will you be? And do you think we… Is it reasonable to expect some sort of opportunities to come around in the next 12 months? I mean just give us a flavour on that.**

Miles Roberts: It's a very good question. I can absolutely assure all of our investors/ commentators, we are here to earn consistent sustainable returns on capital that are above our cost of capital. That is our primary measure. If you can't earn your cost of capital in our view, ultimately your business is -- won't succeed. You either can't pay your dividend; you can't pay your interest, or you can't cover your depreciation. It's as simple as that. So that is what we're focused on, whether it's organic growth in investment or acquisition.

When we look at those acquisition opportunities, you're absolutely right, Myles, we have a very strong balance sheet. Not only are we disposing of Spicers, what I think is a very attractive multiple of 6.9 times historic EBITDA, but the Group is very cash generative as well, so our debt is falling. At the end of the day, we have customers that really want to work with us. We have a very strong position in the UK and France. The industry is still fragmented and there are a number of opportunities that we believe are out there, but we'll be disciplined. If they come in six months, they come in six. If they come in 12, they come in 12. If they come in 18, they come in 18, but there is -- there's quite an attractive -- we believe there's quite an attractive range of opportunities.

Myles Allsop: Okay thanks.

Miles Roberts: No, thank you.

Operator: Ross Gilardi from Bank of America is online with a question.

Ross Gilardi: Yeah, good morning. Thank you. **I'm just curious, Miles, what are you seeing in terms of customers trading into more recycled packaging out of other mediums? And clearly with 3% like-for-like growth, your volumes are growing faster than the overall economy, so who's on the other side of that trade right now?**

Miles Roberts: I think it's a great question. The industry statistics aren't as sort of developed as in some other sectors, but it's clear that recycled is taking share. And that's one of the reasons that we're focused on it, so I don't think that's going to end. And if we look in there, all I can tell is what we're doing and simple things about reducing the amount of Kraft. You look at it and say, "I mean why do we need Kraft? How can we at every opportunity look to replace that for a more sustainable source?" And our customers are very, very much behind that. And previously some people think: Well it's got to be Kraft. Well it doesn't. It just doesn't have to be Kraft, so we're taking share there. And I have to say, we're taking share from other formats such as plastics in terms of flexibles and more sort of rigid containers, but it's also the growth of shelf-ready, and it is a new format. So in effect, we aren't taking share from other sectors, it is a new format that is taking costs out of the supply chain. We said that would continue in the UK and it is and we said it was going to grow in France and it really is starting to grow in France. So we're taking some share from some other categories, but it's that development, particularly the shelf-ready that we are -- we're very pleased with. And of course, you have a number of other innovations to support that such as R-Flute® and I think -- I just -- I think there's just a lot of long-term development here for our sector. That's why we said 3%. It was designed to be GDP plus growth, and that's exactly what we're delivering.

Ross Gilardi: Okay great. And then just one other question. **If you look at your full year results and you look at Continental Europe and what you disclosed about Otor, it's pretty clear that your French margin, your legacy business in France has margins that are still well below where Otor is right now. And what are the prospects for getting that margin closer to where Otor is, and can you give us any clues on timing for that?**

Miles Roberts: I mean we said… I mean you're absolutely right, Ross. And of course in terms of return on capital, the UK has had quite an issue over the last few years. And in our announcement of our targets of a return on capital between 12 and 15 percent, return on sales consistent between 7 and 9 percent, to reach those targets does mean that the UK and the legacy Continental European business have to improve. There are a number of things that we've talked about there, particularly around procurement and around synergies in terms of bringing a lot of the Group functions together, and both of those will have quite an effect on -- not only on the Continent in the legacy business but in the UK. But as we stand here, we're making good progress towards them. It's just getting people together, consistently working through the issues being very focused on it. So it's… We're pleased with the progress.

Ross Gilardi: Thank you very much.

Miles Roberts: Thanks, Ross.

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

Donal O'Neill : Hi, guys. Good morning. A few questions for me. **The first one maybe just to pick up a little bit on what you said earlier about margins. If you were to strip out the Spicers' business for the quarter, would your margins have been in line with your 7-to-9% target?**

Miles Roberts: Yeah.

Steve Dryden: Yeah. Hi, Donal. Steve here. Strip Spicers out, we're making progress compared to where we were as of the 30th of April 2011 towards that 7-to-9%, but we don't want to get specific in terms of after one quarter if the margin corrects.

Donal O'Neill: That's fine.

Steve Dryden: Key thing in the notice, we say we're making progress on improving our margins.

Donal O'Neill: Great. **In terms of the FMCG, obviously, as you said, you're 75% of your business in the UK is FMCG and 65% in Europe. Do you think it's possible or are you targeting to try and get the European business up to 75% as well or higher than that?**

Miles Roberts: We certainly want to see Europe grow. It is slightly concerning just the growth of shelf-ready packaging, et cetera, but ultimately we would like to see those shares in FMCG on the Continent more towards where the UK is. So overall for the Group, we should be between 70 and 80 percent, and we're below that today. We knew this was a robust sector and we are seeing that consistently coming through, and I think this addresses one of the issues with this industry about the cyclicality. If we're getting the demand right, we're short in paper, long in box and fibre, we can see it in the results. It makes a hell of a difference to the pattern of returns that we're making.

Donal O'Neill: Yep. **And just finally on R-Flute®, you said the demand in the UK is obviously strong and there's been a good pick up in France as well. Whereabouts would you say in terms of your own production and what R-Flute® represents of that now?**

Miles Roberts: We don't disclose that in detail, but it's been very successful in the UK. I mean it is a -- it's a very significant part and we see no reason why we can't repeat that success in France hence we're putting it in, and I have to say the take up from customers in France has been excellent. I said that's one of the reasons that we have grown consistently against a very strong comparator to last year by a further 3%, so we've got some really high hopes for that on the Continent, and it's certainly bearing out.

Donal O'Neill: Okay. **Just maybe as guideline, would you say it's 20/30%, in that kind of region?**

Miles Roberts: We find it's very sensitive that number. I would say that it is a significant part now of our UK business. It's actually being a relative newcomer to the industry, looking at it cold, it's extremely successful.

Donal O'Neill: Okay. All right, that's great, and thanks for your time, guys.

Miles Roberts: Not at all.

Operator: Markus Almerud from Morgan Stanley is online with a question.

Markus Almerud: Hi. Markus Almerud, Morgan Stanley, here. A couple of further questions. **First of all, can you remind us how long your visibility is and how long your order books are?**

Miles Roberts: Yeah, again it's a very good question. Because we're FMCG, basically our order visibility is a few days by customer. There're no guaranteed volumes, guaranteed take off, it's nothing like at that at all. If we look at the average duration of our contracts, this isn't pricing, this is the contracts, then typically it's roundabout I think probably a couple of years, something like that, that we -- before we get into sort of a review of their contracts. They tend to last about two... In terms of visibility, there's very, very little, and that reflects our customers. If you say to our ultimate customer, if you go to retail like Tesco and say, "What's your order book like?" they'll say, "We don't have one." That's FMCG.

Markus Almerud: Yeah. Okay, fair enough. **Then I'm just a bit curious, do you see any difference in the cycle and the strength in the UK and in Continental Europe or is it about the same? Are trading conditions the same?**

Miles Roberts: Yeah, I mean we're in a slightly difficult position because we've made quite a significant acquisition in France and we continue to really benefit from that. So overall, FMCG has been strong, slightly stronger on the Continent as we get the benefit of our revenue synergies, et cetera, with the acquisition. So if anything, slightly stronger on the Continent in France, but for FMCG, we're seeing it being pretty good across the piece really.

Markus Almerud: Okay. **And do you see it… Do you still think you'll continue to gain share?**

Miles Roberts: We certainly hope so. We're doing our very best. It obviously depends on how our competitors, et cetera, respond but...

Markus Almerud: **But you think you are?**

Miles Roberts: Oh, we are, and we certainly hope to continue that. We can see where… We know where we can improve. We're not perfect by any means. There's a lot coming through. We're putting more investment into the commercial side, into product development. Our service is industry leading, but it can still be better, and I believe there's margin there for our shareholders by continuing to improve that. So that's our target. It's what's happened. There's a lot more to do. We're not running out of ideas by any means. So, yeah, that's our forecast.

Markus Almerud: Okay perfect. **And then finally on OCC side, what are you seeing there? I mean we've seen a bit of weakness as the Chinese went over to buy in Europe instead, and have you seen any change of this and are buyers coming back? And, yeah, what are you seeing on the OCC side?**

Miles Roberts: Yeah. I mean this is a market that changes almost by the day. And in… We have such a substantial recycling business, as you know, where we collect directly from the retailers. We've got fantastic positions there, so we've got a very, very close handle on that, and prices have risen consistently over the last 15 months, probably until the last couple of months where they've edged off. I think very recently there's been... I think literally just in the last few weeks, there's been a very marginal decline. But overall, it's still hugely up from where it was a year ago, six months ago, whether there has been some recent flattening off. We just have to see how it goes over the next few months. Production will see increases with Christmas coming up, et cetera. There's no doubt some sectors.... There is production down, so the availability of OCC is in some sectors is more restricted. So we're not actually expecting any huge declines coming, which I think probably underpins some of the raw material cost increases, such as paper.

Markus Almerud: Okay, perfect. Thank you very much.

Miles Roberts: Sure.

Operator: *Harry Philips from Evolution is online with a question.*

Harry Philips: Good morning, everyone. A few questions please. **You mentioned in June about how Otor was picking up new business wins sort of cross Group, if you like. I was just wondering how that trend has continued through the summer. In terms of the comments on working capital and the absolute reductions, Steve, are you still confident you can keep that absolute reduction for the balance of the year? And then in terms of moving recycling into Europe, is there any sort of update as to where you are and plans about how you're going to go about it, please?**

Miles Roberts: Yeah. Look, if we sort of cut this up, if I just talk about the recycling growth in Europe, a bit on Otor, and Steve will take you through working capital. With the recycling, we really are very excited about this. We have signed up Tesco's operations throughout Poland now and we're starting on that collection. It's an absolutely super our first big contract for us on the Continent. We believe there is substantial opportunity for our recycling business to grow there because recovery rates are so low and we secured all of Tesco. It's not 50 or 60 percent of it, it's all of it in Poland. And as we know, they've got operations elsewhere. We start in Hungary with them as well, and then there are further opportunities with other retailers who we are talking to there and it's all on our model of service and zero to landfill, the full box, the box cycle, which we guarantee. So this is looking very exciting.

And with Otor, we do have the revenue synergies are coming through. It has been growing very nicely. I should say that the Otor acquisition is packaging, is what we call "pre print." And basically, in terms of its paper usage, it's roundabout 25% below where the printing is using more sort of traditional methods of post print, so you're saving typically roundabout 25% of the paper content. Paper prices are high. They can move about a bit, but I think they're going to stay high for our outlook, and that absolutely is where Otor wins. Great products. Great service, and it's taking share and I just think that's going to be a long-term trend, so we have… We're very, very encouraged by the development of this business with hopefully more to come.

But, Steve, working capital.

Steve Dryden: Yeah, Harry, Steve here. Just on the working capital, as we say, absolute -- in terms of absolute level, it's actually lower than last year, and that's despite volume growth 3%, total revenue growth 13%, and the inclusion of the acquisition of Otor, so great performance after the first quarter. We still see an awful lot of opportunity in areas like inventory, so I'm comfortable that we're going to be able to sort of maintain that and improve performance through the year.

Harry Philips: Great stuff. Many thanks.

Operator: *Hector Forsythe from Oriel Securities is online with a question.*

Hector Forsythe: Morning, guys. It's Hector Forsythe. **Just a quick couple questions on the price recovery. Clearly you've done an extremely good job during the first quarter in terms of getting those -- that price improvement through. Can you just talk us through how that has trended through the first quarter and post the end of the first quarter? Are you seeing any change in the market acceptance of price increases coming through? Clearly you've got a change in the background in terms of the paper price, but you still got some energy price to recover. So if you can just talk us through how that's working.**

Miles Roberts: Yeah. Actually, no, we've done quite a lot of work here in terms of pricing of our products again to reduce the cyclicality as we seek to recover much more quickly any cost increases. On the other side of it, if prices change, then raw material cost change and our prices go down. But for shareholders, you won't see the lows as seen before, but equally you won't see the absolute peaks either. It'll be much, much more consistent, but it does allow us to recover a number of costs of which logistics, paper, energy, et cetera, is -- are all separate components. Our price recovery over the last four months has been pretty consistent in recovering the increases from the previous three, four, five, six months, and those price increases continue to go through as we speak. Now clearly if raw material costs start to flatten off, energy costs start to flatten off, then we'll see our price recovery start to flatten off. But all of this is about maintaining our profitability. I say many times, people, I'm not concerned by raw material or energy costs. What I'm concerned about is: How do we price and recover that? If price of paper goes up 50 pounds a tonne, well it goes up 50 pounds a tonne, how do we recover that? And it's because of that position of being so short in paper that we can have this view. So we have seen consistent recovery. If raw materials and distribution, energy costs level off, then we'll see a levelling off on that. But at the moment, we are still in recovery mode. There's still quite a few price increases coming through.

Hector Forsythe: **And they're being accepted properly by the customers?**

Miles Roberts: Well it's because of the way we're trying to work with them. They know if prices go down, then they'll get the reduction. So, no, people aren't happy about it, but I think we just have -- I think we have quite a transparent way of working and our big customers, we're growing ahead of the market, they wouldn't be growing with us unless they were -- if they're unhappy. I mean they are very demanding, so we're looking at that and thinking: I think we've got it about right, but time will tell.

Hector Forsythe: Okay, Miles, thank you very much.

Miles Roberts: Not at all.

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

Miles Roberts: Well thank you, everybody, for your interest in DS Smith and for listening to our call today. In summary, trading has been good with the like-for-like volumes in corrugated packaging up 3% and with further good progress on margins and cash flow. As I've said, we remain confident in the outlook for the year. Thank you again for your time.

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