Operating Review

PACKAGING

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Paper and Corrugated Packaging Market Overview

THE CORRUGATED PACKAGING MARKET

The European market for corrugated packaging in 2009 is estimated to have been approximately 33 billion square metres[1], equivalent to circa 17.5 million tonnes, of which the UK market is estimated to be 10%. Demand for corrugated packaging is principally influenced by overall economic activity and manufacturing output.

In the calendar year 2009, the European market for corrugated packaging, measured in square metres, declined by 6.7%. Demand in western Europe fell by 7.7% and within this the UK market fell by 8.1%. Demand in eastern and central Europe fared slightly better and was down by 0.9% in 2009. Owing to cost and environmental pressures, there is a continuing emphasis in most markets on reducing the average weight of packaging. As a result, European demand, when measured by weight, declined by 7.0% and the UK market, which is at the forefront of the 'light-weighting' trend, fell by 10.1%. Across Europe, demand was weak, in line with the economic downturn, especially in the first half of the year. The first quarter in 2010 has seen an improvement in demand and this trend is expected to continue as the year progresses.

Usage of corrugated packaging (boxes) for the fast-moving consumer goods (FMCG) sector, which accounts for approximately two-thirds of the corrugated market, has been affected by the slow-down in retail demand but has remained significantly stronger than that for industrial market sectors. Demand from the FMCG sector continues to benefit from the trend towards the use of retail-ready packaging (RRP), which can be readily converted from its initial role as a protective transit pack into a box or tray that can be placed on display in the retail store. RRP benefits retailers by reducing the manual work involved in loading goods onto store shelves and reducing the amount of damage to goods in store, while enabling products to be presented more attractively. RRP requires more sophisticated packaging manufacturing capabilities for cutting, printing and gluing the corrugated board to form the more complicated box structures. The increased proportion of these higher value-added boxes, often requiring multi-passes within the production process, has contributed to capacity utilisation across the corrugated industry remaining higher than would be indicated by the overall level of demand.

Usage of corrugated packaging for the home delivery of products continues to grow in association with the growth of purchasing through the internet. In contrast, the usage of boxes in most industrial manufacturing sectors has been severely affected by the sharp downturn in industrial activity throughout Europe. Demand from the automotive, construction and chemical industries has been particularly weak.

Within the overall weaker market for boxes there is a continuing strong trend towards the greater use of lighter-weight corrugated packaging. This trend is being driven not only by the continuing pressure through the supply chain to reduce the cost of packaging but also the increased attention being given to the quantity and type of packaging being used in order to reduce the amount of waste going to landfill. Corrugated packaging is fully recyclable and the trend towards use of lighter-weight boxes has been enabled by the increasing availability of high-quality lightweight recycled corrugated case material (CCM) with good strength characteristics. This lightweight CCM allows box manufacturers to produce packaging with high performance characteristics while reducing the weight of material used.

Supply of corrugated board and boxes is generally relatively local to the point of production, with a typical operational radius of approximately 150 miles, owing to customers' service requirements and the proportionately high transport costs for a low-density product. Pricing and margins in corrugated packaging are strongly influenced by developments in the price of CCM, the paper that is the principal component in corrugated packaging, and which typically accounts for around 50% of the cost of a box.

THE CORRUGATED CASE MATERIAL MARKET

Whereas boxes are generally sold locally, CCM is sold on a pan-European basis and pricing is therefore affected by pan-European supply and demand. The market for CCM in Europe is dependent upon European demand for corrugated packaging, as the imports and exports of unfilled boxes are negligible. Approximately 80% of the CCM used in Europe is made from recycled fibre, with the balance principally comprising kraftliner, which is made from virgin wood pulp.

The lower demand for boxes has resulted in reduced demand for CCM. However, within the overall CCM market there is strong demand for high quality, lightweight CCM to produce lighter-weight packaging. The growth in the usage of lightweight CCM continues to be limited by the available supply of lightweight paper as the majority of the existing CCM machines are unable to manufacture lightweight papers cost-effectively or to an acceptable quality. This increased demand for high-quality lightweight CCM is resulting in the addition of new CCM capacity capable of producing lightweight paper.

1 Source: European Federation of Corrugated Board Manufacturers

OUR UK CORRUGATED PACKAGING SUPPLY CHAIN

DS Smith's operations play a significant role in the first three stages of the corrugated packaging recycling process. The fibres in corrugated boxes can be back on the shelf in-store within 14 days of disposal; their re-use minimises waste disposal to landfill. In the UK, over 80% of corrugated packaging is recycled.

Corrugated boxes protect products, reduce product wastage, enable more efficient and lower-cost handling and transportation and are increasingly used to provide strong visual display in-store. Approximately two-thirds are used for food, beverages and other fast-moving consumer goods.

In January 2009, the Group started production of its 'K-light' lightweight CCM product at Kemsley. Other European lightweight producers started up new machines located in Poland and Hungary during the second half of 2009 and in Germany in 2010. This new capacity will produce circa 1.5 million tonnes per annum when it is fully operational. Additionally, it has been reported in the press that a new 400,000 tonne machine is planned for 2012 in the UK. It is anticipated that the production from the new machines will principally be targeted at satisfying the rapidly growing pan-European demand for lightweight paper.

During 2008 and 2009, a number of closures of older recycled CCM machines, representing circa 0.8 million tonnes of capacity, were implemented across the industry. Despite these closures it is estimated that there is currently an oversupply of some three million tonnes of CCM in Europe. There are no new machines planned until 2012 and with demand picking up, this oversupply is expected to lessen considerably over the next two years. Additionally, the continuing economic viability of some existing older machines across the industry is under pressure due to having a much higher cost base relative to new machines, especially in terms of fibre costs.

CCM AND BOX PRICES

Finished recycled paper stocks in 2010 have fallen rapidly and are below levels seen in 2006. This, coupled with a rapid pick-up in demand at the start of the year has led to a change in the pricing environment in Europe. As a result, CCM prices in both the UK and continental Europe increased by 60% in the final quarter of 2009 and the first quarter of 2010. These increases in CCM prices have necessarily resulted in increases in box prices.

WASTE PAPER

Waste paper, the principal raw material for recycled CCM, is a globally traded commodity. The price of old corrugated containers (OCC), the principal grade of waste paper used for producing CCM rose throughout the financial year, increasing by over 50%. Three main factors drove the price increases: demand from Asia increased, including demand from India and Indonesia, as well as the more established demand from China; waste paper collected was down due to lower economic activity; and there was demand from new European mills using OCC to make recycled CCM.

UK Paper and Corrugated Packaging

Good productivity and cost reductions offset the effects of lower demand and rising input costs.

	2009/10	2008/09
Revenue – £m	**750.2**	785.8
Adjusted operating profit – £m*	**35.4**	36.5
Adjusted EBITDA – £m*	**74.4**	73.2
Segment key performance indicators:		
Revenue growth – %	**(4.5)%**	4.3%
Adjusted return on sales – %*	**4.7%**	4.6%
Adjusted EBITDA margin – %*	**9.9%**	9.3%
Adjusted return on average capital employed – %*	**6.6%**	6.7%

* before exceptional charge of £4.5m (2008/09: £18.2m)

2009/10 PERFORMANCE

Results in the UK Paper and Corrugated Packaging segment were affected by lower demand for packaging and the rising cost of raw materials. Our corrugated box business performed well, despite a lower demand for boxes, through its focus on adding value for FMCG customers with innovative products and services. Our paper business began to benefit from rising CCM prices towards the end of the financial year. Revenue fell 4.5% to £750.2 million. Adjusted operating profit was marginally lower at £35.4 million (2008/09: £36.5 million).

Our waste paper recovery and recycling business, Severnside Recycling, was affected by the rapidly increasing cost of recovered paper, which increased by over 50% during the financial year, due to resurgent demand from Asia. The amount of material available for collection was lower due to the reduced levels of activity at retailers and other businesses. Despite this, volumes increased due to the acquisition of new customers. In addition to fulfilling its primary role of securing the required quantities of fibre for our UK paper mills, Severnside developed further its value-added waste management services in response to growing demand, which is being stimulated by government action to reduce the amount of waste going to landfill. During the course of the year, Severnside and our UK box business, DS Smith Packaging, have further strengthened their marketing collaboration for our 'cradle-to-cradle' environmental capability. In April 2009, Severnside announced that it had entered a contractual relationship with Marks & Spencer (M&S) to help the retailer to achieve its 'Plan A' goal of sending zero waste to landfill by 2012. Severnside will provide the management systems for dealing with waste generated by all stores and distribution centres. Fibre-based packaging material produced by M&S will be reprocessed through Severnside's UK facilities. Any residual waste, mainly food waste, will be processed through a network of landfill diversion technologies, focusing on anaerobic digestion facilities being developed by strategic partner, Shanks Group plc. Customers are increasingly recognising the benefits of the Group's expertise in the design of waste-minimising packaging, the manufacture of fully recyclable boxes and waste recycling and disposal services.

Revenue at St Regis, our UK paper business, fell slightly, due to the ending of a tolling contract to supply M-real with copier paper, which was mostly mitigated by the full-year contribution from the new lightweight paper machine at Kemsley. Waste paper costs increased, but the business benefited from the increase in CCM prices in the second half of the financial year.

In early 2009, production of lightweight CCM ('K-light') commenced. The quality of the 'K-light' product being produced continues to exceed our expectations and there is strong demand for this lightweight paper despite the weaker demand for CCM as a whole. We believe that this investment has materially strengthened the long-term competitiveness of our UK Paper and Corrugated Packaging business. It has established us as a leader in high-quality, high-performance, lighter-weight packaging and given us a significant capability as well as an increased share of this growing market.

DS Smith Packaging, our UK box business, achieved a good result, strengthening its position in a weaker overall market. Increasing CCM costs necessitated price increases from the second half of the year, which continue to be implemented. We benefited from our broad exposure to the FMCG sector of the market and particularly from our focus on RRP, which continues to increase its share of the market. We are continuing to develop our innovative supply chain support service, designing and manufacturing packaging solutions that will reduce customers' overall transportation and handling costs, and hence their carbon footprint. Our sheet-feeding operation, which supplies corrugated sheet to box converters, increased its market share during the year, aided by structural changes in the market.

As we enter 2010/11, we are experiencing modest improvements in demand offset by increasing waste paper input costs and CCM prices. We will build on the strong market positions achieved to date and are well positioned for growth.

Continental European Corrugated Packaging

Despite growth in our share of the FMCG market, results were affected by weak demand and higher input costs.

	2009/10	2008/09
Revenue – £m	**355.4**	363.4
Adjusted operating profit – £m*	**22.9**	30.4
Adjusted EBITDA – £m*	**38.7**	45.8
Segment key performance indicators:		
Revenue growth – %	**(2.2)%**	5.0%
Adjusted return on sales – %*	**6.4%**	8.4%
Adjusted EBITDA margin – %*	**10.9%**	12.6%
Adjusted return on average capital employed – %*	**11.9%**	15.2%

* before exceptional charge of £7.1m (2008/09: £24.7m)

2009/10 PERFORMANCE

The Continental European Corrugated Packaging segment saw demand recovering at the end of the fiscal year. A 4% volume improvement in the fourth quarter, year-on-year, resulted in volume for the full year increasing by 2%. Revenue fell by 2.2% to £355.4 million (2008/09: £363.4 million), mostly due to lower selling prices at the beginning of the fiscal year. This segment, which is a substantial net buyer of paper, suffered from increasing CCM prices, partially offset by a significant reduction in conversion costs. Operating profit decreased by 24.7% to £22.9 million (2008/09: £30.4 million). Excluding the effects of foreign exchange translation, revenue was £18.2 million lower than in 2008/09. Operating profit, excluding the effects of foreign exchange was £8.1 million lower than in the prior year.

The 2% increase in volume for the full year was a result of our continental European business having focused strongly on developing its sales to the fast moving consumer goods (FMCG) market. The sales to this market increased by almost 10%, taking its share of our business to 48%, and compensated for lower industrial sales.

In our established markets, the French paper business, which focuses on supplying speciality products, suffered from higher input (waste paper) costs, particularly in the second half of the year. Our French corrugated packaging business increased sales to the FMCG sector by over 10%. Our particularly strong market position in heavy-duty packaging for the industrial sector in France continued to be affected by the sharply lower level of activity in some of its customers' industries. Our Italian business performed particularly well in a difficult trading environment.

In our developing markets, the Polish business continued to develop its speciality product portfolio, gaining share in a broadly static market. We are taking advantage of the investments we have made over a number of years and our focus on developing sales of higher value-added products. Our facilities in Poland also serve the adjacent markets in the Czech Republic, Hungary, Slovakia, Russia and Lithuania.

Although operating results at our Ukrainian associate business Rubezhansk, which is reported under associates, were affected by weaker sales volume and margin pressure from rising costs, it remained profitable and cash generative. As explained in last year's annual report, we fully impaired the carrying value of the investment in this business due to the covenant breach in the large, non-recourse to DS Smith, US dollar denominated loan and we remain in discussion with the lenders.

In 2010/11, we expect margins to come under increased pressure from higher input costs, but we expect to benefit from higher sales volumes. Our priorities are to maintain good levels of profitability in our three principal markets – France, Italy and Poland – through increased selling prices, volume growth and control of conversion costs. We will continue to invest in and develop the Polish business in both conventional and speciality products and concentrate on supplying the higher value-added product sectors in all our markets.

Plastic Packaging

Results recovered strongly due to improvements in both our major segments.

	2009/10	2008/09
Revenue – £m	**231.3**	236.9
Adjusted operating profit – £m*	**15.5**	7.0
Adjusted EBITDA – £m*	**27.6**	19.2
Segment key performance indicators:		
Revenue growth – %	**(2.4)%**	6.0%
Adjusted return on sales – %*	**6.7%**	3.0%
Adjusted EBITDA margin – %*	**11.9%**	8.1%
Adjusted return on average capital employed – %*	**12.6%**	5.3%

* before exceptional income of £0.1m (2008/09: exceptional charge of £4.0m)

MARKET OVERVIEW

Returnable transit packaging (RTP) products are mostly used within the retail, automotive, electronics and beverage sectors. Demand is heavily influenced by industry sector activity levels. RTP is often a capital purchase for our customers, being driven by particular projects, hence annual demand can be uneven. The European market for RTP is fragmented into many product subsectors and has a large number of suppliers. In western Europe, the markets we serve are estimated to have declined in 2009 as a result of the slow-down in industrial and retail activity. The previous trend towards the use of multi-trip, reusable packaging on cost and environmental grounds has reduced in recent years, although there remain many market sectors that are well suited to returnable systems. This slowdown in demand has been partly a result of the fluctuations in polymer costs and partly a result of the general decline in economic activity.

The global market for liquid packaging and dispensing (LP&D) products is estimated to be approximately £500 million. The principal uses of bag-in-box packaging are for wine, agricultural produce (such as fruit juice and dairy products) and food service applications such as carbonated soft drink concentrate (for the hotel and restaurant industries). The market for dispensing products (principally taps), other than for bag-in-box systems, is fragmented across a wide range of applications. DS Smith Plastics is a major supplier to the wine and liquid detergent sector; the latter has grown strongly in recent years in the USA.

Polymer prices fell during 2009, then began to increase rapidly in the second half of the year.

2009/10 PERFORMANCE

DS Smith Plastics' revenue decreased by 2.4% to £231.3 million (2008/09: £236.9 million), including the positive effect of foreign exchange translation. Results were higher in both of our major sectors such that overall adjusted operating profit more than doubled to £15.5 million. The effects of foreign exchange translation improved revenue and operating profit by £11.2 million and £0.8 million respectively compared with 2008/09.

In RTP, revenue excluding the impact of foreign exchange translation accounted for 43% of the segment revenue and was 6.2% lower due to weak and variable demand from almost all its main customer sectors. Sales to the construction and automotive sectors continued to be weak and our beverage crate business was significantly affected by the deferral by our customers of anticipated crate replacement programmes.

In LP&D, revenue excluding the impact of foreign exchange translation accounted for 57% of the segment and fell by 2.3%. Our USA operations showed a strong performance, partly due to the development of new market sectors for bag-in-box packaging. Our European operations also improved profits, benefiting from the restructuring completed last year and sales of existing products into new markets.

In January 2010, we completed the sale of Demes Logistics, a small plastics logistics business based mainly in Germany. The business had gross assets of €11.2 million.

In 2010/11, we expect to build further on the strong recovery in LP&D and to see growth in demand for our RTP products.

Office Products Wholesaling

Profit was flat, assisted by a good performance in continental Europe.

	2009/10	2008/09
Revenue – £m	**733.7**	720.5
Adjusted operating profit – £m*	**20.2**	20.1
Adjusted EBITDA – £m*	**25.3**	25.7
Segment key performance indicators:		
Revenue growth – %	**1.8%**	11.7%
Adjusted return on sales – %*	**2.8%**	2.8%
Adjusted EBITDA margin – %*	**3.4%**	3.6%
Adjusted return on average capital employed – %*	**16.9%**	15.2%

* before exceptional charge of £1.8m (2008/09: £3.7m)

MARKET OVERVIEW

The office products markets of the UK, France and Germany, in which Spicers currently has approximately 85% of its sales, are estimated to be worth approximately £5 billion, €6 billion and €7 billion respectively, at manufacturers' selling prices. The demand for office products is principally influenced by the level of economic activity. The value of the markets in which Spicers operates fell in 2009, with the traditional stationery sector declining significantly although the electronic office supplies (EOS) sector continued to show modest growth. EOS accounts for approximately 50% of the total office products market. It is especially price-competitive on the high-volume EOS products.

The relative shares of the various supply channels to the end-user market differ by country. Spicers principally supplies office products dealers and resellers. In the countries in which Spicers operates, this channel accounts, on average, for approximately 35% of the total office products market. The share of the market held by dealers has been relatively stable in recent years. Office products dealers primarily sell to small and medium-sized organisations, generally offer a high standard of service to their customers and source most of their products either from wholesalers or direct from manufacturers.

2009/10 PERFORMANCE

Spicers showed overall sales growth, aided by the translation benefits of the stronger euro. Despite the adverse impact of the economic environment on the demand for office products, revenue increased by 1.8% to £733.7 million (2008/09: £720.5 million). Adjusted operating profit increased marginally at £20.2 million, with improved results in all markets except Spain and Ireland. The effects of foreign exchange translation improved revenue by £20.1 million and operating profit by £1.1 million compared with 2008/09.

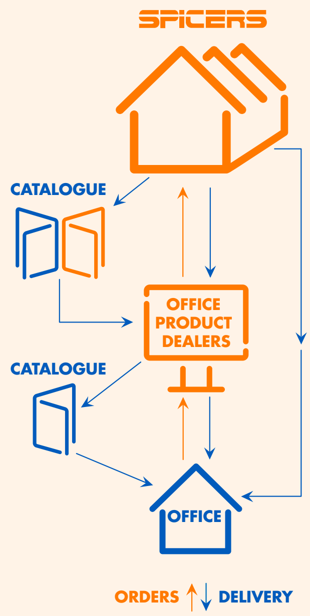
In the UK, which accounts for approximately half of our office products wholesaling revenue, sales declined slightly. However, this modest decline masks a more significant decline in traditional office products, partly offset by growth in lower margin EOS. Despite the lower sales and mix change, our actions to focus on efficiency, reduce the cost to sales ratio and on maintaining overall margins, led to improved profits. Action will continue to be taken to improve the sales mix and to raise efficiency levels further, with the aim of continuing the positive profit trend.

In continental Europe, our well-established businesses in France, Germany and the Benelux region performed solidly despite the decline in the overall market. Our Italian operation once again showed good profit growth, consolidating its position as a significant supplier in this market.

Under the leadership of George Adams, who was appointed to the role of Divisional Chief Executive of Spicers in June 2009, the management team has been further strengthened and the Spicers business has further developed its strategy. New initiatives are being created to support dealers with new ranges and we are investing in strengthening our service capability.

In the current year we expect to build on the achievements of 2009/10 and benefit further from the restructuring actions taken to date. We will build on our good overall performance in continental Europe while continuing to drive profit improvement in the UK. We will focus on improving our overall sales levels, primarily in traditional office products, and on tight cost control. We believe that Spicers is well placed to take advantage of improving economic conditions, due to its strong market positions and its thorough understanding of supply chain management.

SPICERS' BUSINESS MODEL



SPICERS

Supplies trade customers – dealers and resellers – with:

- Everything for the office, except computers – up to 22,000 product lines across Europe, branded and own-label
- Marketing support – catalogues/promotions
- Business development support
- E-commerce systems
- Fast service – same/next-day delivery
- Fulfilment service – orders delivered to dealers or direct to end-users

DEALERS AND RESELLERS

- Sell to end-users
- Some hold stock
- Some are stockless and use Spicers as their fulfilment provider
- Source products from Spicers; may also buy from manufacturers

OFFICE END-USERS

- Offices of all sizes – from one person to large businesses – buy their office products from dealers
- Dealers also sell to other organisations such as schools and sometimes sell directly to consumers
- End-users can buy from the dealer customers of Spicers not only traditional stationery and electronic office supplies but also office furniture, janitorial supplies and office catering and vending provisions