

Profitability of major suppliers

Introduction

1. This appendix provides information on the profitability of the major suppliers of sheet.
2. We had two main sources of information on profitability:
 - (a) management accounts for DS Smith and Linpac; and
 - (b) responses to our competitor questionnaire, asking about costs and profits at plant level.

Of these two sources, the management accounts were the more authoritative and comprehensive and were accorded greater weight in our overall assessment, although they only dealt with the two companies involved in the merger.

Management accounts

3. We examined the financial performance of DS Smith and Linpac, with particular reference to performance in those markets that were affected by the merger.
4. Table 1 shows the returns on average trading capital by segment for DS Smith Packaging (DSSP). The two principal activities that relate to the market for corrugated sheet are conventional integrated plants and sheet feeding. By comparison, DS Smith has told us that its pre-tax nominal cost of capital was [X] per cent.

TABLE 1 DSSP: return on average trading capital by segment

	<i>per cent</i>		
	<i>Years ended 30 April</i>		
	2002	2003	2004
Conventional Heavy duty Speciality Sheet feeding Sheet plants DSSP	<div style="font-size: 4em; line-height: 1;">(</div> <div style="display: flex; justify-content: space-around; align-items: center;"> <div style="text-align: center;"> \times </div> </div> <div style="font-size: 4em; line-height: 1;">)</div>		

Source: DS Smith.

5. Table 1 indicates that DS Smith was not earning above-normal returns in either its conventional corrugated or its sheet feeding segments. In 2004, DS Smith's activities in both areas underperformed with respect to the cost of capital and to other parts of the business (though returns to sheet feeding in 2002 and 2003 were close to the cost of capital).
6. Financial comparisons between DS Smith and Linpac suggested that Linpac was earning higher operating margins for both sheet feeding and integrated plants.

7. Table 2 shows our calculation of Linpac's financial performance in the six years to 2003, based on data from its audited accounts. (As explained in paragraph 2.11, Linpac transferred its moulded foams business to another part of the Linpac Group and acquired the Raleigh business in February 2004, but the business finally acquired by DS Smith was reasonably similar to that in the audited accounts.)

TABLE 2 Linpac: summary of financial performance, six years to 2003

	<i>per cent</i>					
	1998	1999	2000	2001	2002	2003
Ratio of operating profit to:						
Sales	1.8	4.4	4.1	3.5	4.0	7.7
Average net operating assets		9.9	10.5	10.0	12.5	26.4

Source: Linpac.

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8. Table 2 shows that Linpac earned a high return on assets in 2003, although it should be noted that this is more than twice the level of returns in each of the preceding four years.
9. Table 3 shows the performance of Linpac's individual businesses in 2003, taken from its management accounts. There were six integrated plants. Other businesses include LINPAC Sacks in Horncastle, the results of the Portuguese operations before they were sold, and LINPAC Moulded Foams (not included in the sale to DS Smith). The formes and stereos business of Raleigh, which was acquired in February 2004 from another LINPAC company before Linpac was sold to DS Smith, is not included in the table.

TABLE 3 Linpac: results by type of business, 2003

	<i>Integrated plants</i>	<i>Sheet feeding</i>	<i>Eastern Box</i>	<i>Other</i>	<i>£ million</i> <i>Total</i>
Sales—external	}				}
Sales—intra-group					
Total sales					
Cost of direct materials					
Gross contribution					
Production costs					
Distribution costs			✂		
Contribution					
Sales and marketing costs					
Administration costs					
Central costs					
Depreciation					
Operating profit					
<i>per cent</i>					
Ratio to sales of:	}				}
Materials					
Production					
Distribution					
Sales and marketing					
Administration					
Central costs					
Depreciation					
Operating profit					
	100.0	100.0	100.0	100.0	100.0

Source: Linpac.

Note: All ratios have been calculated from unrounded data.

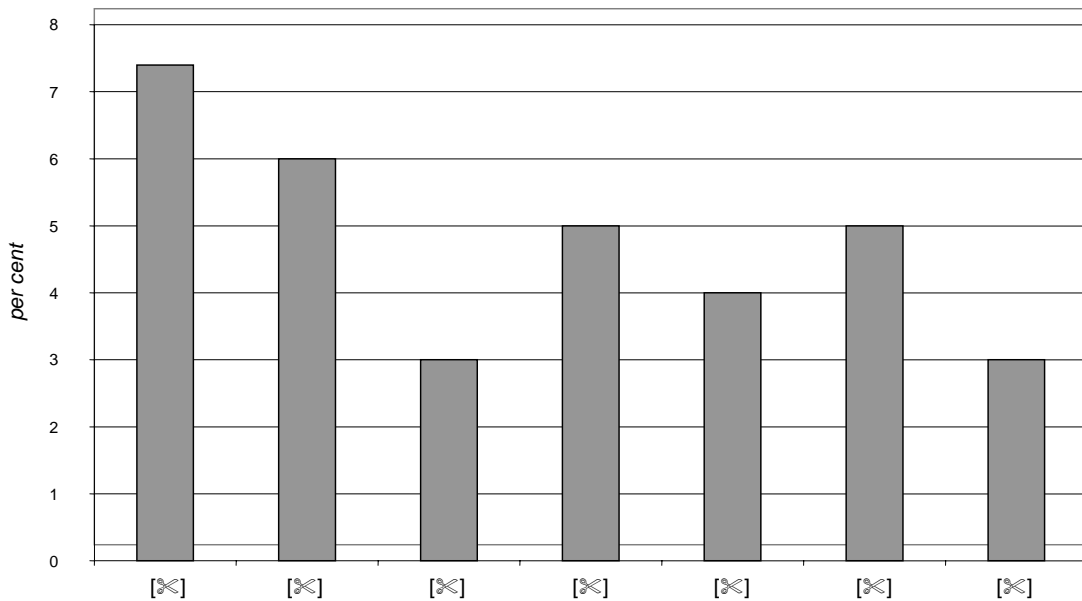
- Table 3 shows that in 2003 most of Linpac's sales and operating profit came from its six integrated plants. A comparison of management accounts showed that its operating margin (operating profit as a percentage of sales) was higher than that of DS Smith's conventional segment in the year to April 2004. The operating margin of the Louth sheet feeder was a little higher than that of DS Smith's Abbey sheet feeding business.

Evidence from the competitor questionnaire

- Figures 1 and 2 show our estimates of operating margin for sheet feeders and integrated plants, calculated from responses to our competitor questionnaire.

FIGURE 1

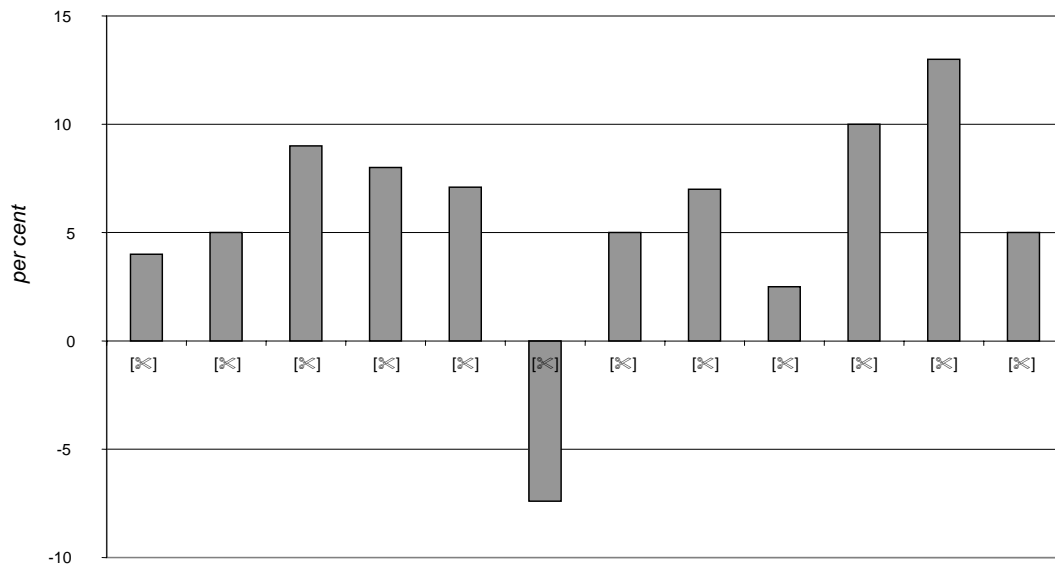
Sheet feeders: operating profits as a percentage of turnover



Source: CC from company data.

FIGURE 2

Integrated plants: operating profits as a percentage of turnover



Source: CC from company data.

- The estimates on which Figures 1 and 2 are based are necessarily less authoritative than the analysis of the management accounts of DS Smith and Linpac. Further, operating margin is generally an inferior indicator of profitability than return on operating assets. To make inferences about the relative returns on assets from information about return on turnover requires an assumption that the asset structure of the companies concerned is similar. However, all the companies which manufacture sheet and cases use similar technologies and machinery, so it is unlikely that there

are significant variations in operating assets between them. Differences in operating margin will therefore be broadly reflected in differences in return on assets.

13. For sheet feeders, estimates of operating margin ranged between 3 per cent of turnover ([REDACTED]) and 7.4 per cent ([REDACTED]). For integrated plants, estimates ranged between losses of 7.4 per cent of turnover ([REDACTED]) to profits of 13 per cent ([REDACTED]). In both charts, DS Smith appeared to be at the lower end of the spectrum and Linpac appeared to be at the upper end. This is consistent with the management accounts of the two companies.
14. Overall, we did not find evidence of above-normal rates of return in either sheet feeding or conventional integrated plants. We are most confident of this statement with respect to DS Smith, then Linpac, and are least confident with respect to the other market participants.