Research Update:

Dutch Paints And Coatings Producer Akzo Nobel N.V. Downgraded To 'BBB' From 'BBB+' On Elevated Leverage; Outlook Stable

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Rating Action Overview

- We expect Akzo Nobel N.V. (Akzo)'s S&P Global Ratings-adjusted funds from operations (FFO) to debt will significantly weaken to 22%-26% in 2022 and remain low at 34%-38% in 2023, before climbing back above the 45% minimum we expected for the previous rating in 2024, due to EBITDA declining under deteriorated market conditions, very high working capital depressing cash flow, and large share buybacks and mergers and acquisitions (M&A) during 2021-2022.
- We understand management is focusing on margin improvement and deleveraging toward its target of below 2x net debt to EBITDA for 2023.
- Therefore, we expect a more cautious capital allocation approach, which may include stable dividends and no new share buyback programs or M&A in 2023, but we still need to see a return to maintaining a prudent financial policy and comfortable rating headroom beyond 2023.
- We lowered our long-term issuer credit and issue ratings on Akzo and its senior unsecured debt to 'BBB' from 'BBB+'.
- The stable outlook reflects that we expect Akzo's EBITDA, profitability, and free operating cash flow (FOCF) to improve in 2023 from 2022 levels despite macroeconomic headwinds, supported by effective price retention and expected raw material price declines. As a result, FFO to debt will increase to comfortably above 30% in the next 12 months--within the 30%-45% we see a commensurate with the 'BBB' rating.

Rating Action Rationale

We expect Akzo's leverage to be elevated in 2022 and 2023 and clearly below the minimum of 45% we view as commensurate with the previous rating. In our view, S&P Global Ratings-adjusted FFO to debt will significantly weaken to 22%-26% in 2022 from 49.4% last year, followed by a gradual recovery to 34%-38% in 2023 and above 45% in 2024. This would mean it's no longer commensurate with a 'BBB+' rating. The leverage deterioration is based on our estimate of an about 20% decline in S&P Global Ratings-adjusted EBITDA to €1.15 billion-€1.20 billion in 2022 from €1.47 billion in 2021, working capital build-up driven by very high raw material prices, and the large share buybacks and M&A over 2021-2022.

Akzo's earnings decline is mainly due to weakening market demand from second-half 2022 and very high cost inflation. Heightened uncertainty in the macroeconomic environment and a significant drop in consumer confidence have led to lower market demand and destocking across distribution channels since second quarter-2022, especially in Europe and China--with the latter also affected by COVID-19-induced restrictions. Given higher recession risks in Europe and the U.S. and a slowdown in GDP growth in China, we expect market demand and sales volumes to continue weakening into 2023. In addition, much higher raw material and logistics costs in 2022 also weighed on profitability. As a result, Akzo released a profit warning in September and suspended its €2 billion EBITDA guidance for 2023 in October.

Besides lower EBITDA, leverage was also elevated by higher debt to finance the build-up of working capital, generous share buybacks, and large M&A. Working capital build-up was €713 million in the first nine months of 2022, compared with €395 million during the same period last year. This was mainly driven by substantial increases in raw material prices and higher stocks in the first half due to supply chain constraints and the company's previous expectation of higher demand. More importantly, we saw large share buybacks of more than €1.1 billion in 2021, followed by €500 million in 2022, and M&A of €530 million this year. The latter was mainly for Grupo Orbis in Colombia, while a cash outflow of a similar amount is expected in 2023 to acquire Kansai Paint's African business. As a result, we expect reported net debt will increase €1.3 billion-€1.4 billon to €3.4 billion-€3.5 billion in 2022 and remain above €3 billion in 2023.

We expect management to return to a more prudent financial policy, which will help build sufficient rating headroom by 2024. We understand that management's focus for 2023 is on margin improvement and deleveraging. We expect to see a more prudent approach regarding capital allocation next year with stable dividends and no new share buyback programs or M&A, except the completion of the acquisition of Kansai's business in Africa announced in June 2022. We understand that the company is committed to maintaining a strong investment-grade rating and aims to recover its net leverage to below 2x (as defined by Akzo), in line with its financial target of 1x-2x net debt to EBITDA. Nevertheless, we note the substantial rating headroom post the specialty chemicals business disposal in 2018 has been fully consumed by shareholder distributions and M&A. More specifically, we expect to see a supportive financial policy, allowing FFO to debt of comfortably above 30% for the 'BBB' issuer credit rating and comfortably above 45% for a higher rating.

Despite challenging economic conditions and weakening market demand, we expect Akzo to improve its EBITDA and profitability in 2023. Amid lower volumes, the company will stick to pricing discipline and maintain current price levels in 2023 for the majority of its businesses, especially decorative paints. Akzo's strong ability to pass on cost increases to customers has been evidenced by the full offset of about €1.7 billion in cumulative raw material and freight cost inflation during the seven quarters to Sept. 30, 2022. In addition, we understand that most customers have a relatively low price sensitivity given the small portion of paints and coatings in their total costs, of less than 5%. That said, Akzo expects raw material costs to decline in 2023 with the first signs of normalization seen in second-half 2022. As a result, margin will expand with maintained pricing and softening raw material costs. Moreover, various cost-cutting measures initiated in the third quarter to mitigate current headwinds are also margin supportive. We expect

S&P Global Ratings-adjusted EBITDA to increase to €1.49 billon-€1.55 billion and EBITDA margin to up to 13.5%-14% in 2023, from 10.5%-11.0% expected for 2022, but still clearly below the 15.3% and 15.9% in 2021 and 2020. However, we note that a more severe than expected recession in Europe and lower growth in the Americas and Asia could result in a more significant weakening in market demand, pressuring pricing and margins in 2023 and delaying Akzo's deleveraging.

Akzo's cash flow profile remains solid with low capital intensity and normalized working capital, supporting continuous deleveraging. Although the company is now focusing on bringing down inventory levels with the first releases to be realized in fourth-quarter 2022, high working capital and lower EBITDA will lead to constrained FOCF of €50 million-€100 million this year, versus €332 million in 2021 and €987 million in 2020. We then expect FOCF to rebound swiftly to above €1 billion in 2023, mainly driven by continuous unwinding of working capital and, to a smaller extent, higher EBITDA. With normalized working capital, the business' low capital expenditure (capex) requirements (about 3% of sales) continue to support solid FOCF.

Outlook

The stable outlook reflects that despite macroeconomic headwinds and weakening market demand, we expect Akzo to improve its EBITDA, profitability, and FOCF in 2023, with FFO to debt increasing to comfortably above 30% in the next 12 months. We consider FFO to debt of 30%-45% commensurate with the 'BBB' rating.

Downside scenario

We could lower the rating if Akzo fails to achieve effective price retention and improve its margin in the next 12-18 months, resulting in adjusted FFO to debt remaining below 30% without prospects of a swift recovery.

Upside scenario

We could raise the rating if Akzo increases its profitability and improves cash flow, strengthening its adjusted FFO to debt to above 45%. A prudent financial policy, including disciplined capex, M&A, and shareholder distributions, would support the rebuilding of rating headroom. For an upgrade, we need to see a strong commitment from management to maintain FFO to debt comfortably above 45%, which is commensurate with a higher rating.

Company Description

Headquartered in the Netherlands, Akzo is a global leading producer of decorative paints (50% of group EBITDA in 2021) and performance coatings (50%). In the past 12 months ended Sept. 30, 2022, it generated total sales of €10.6 billion and S&P Global Ratings-adjusted EBITDA of €1.17 billion. In 2021, Akzo derived about 41% of its revenue from decorative paints, 20% from industrial coatings, 14% from powder coatings, 13% from auto and specialty coatings, and 12% from marine and protective coatings. The company has a global footprint with 50% of sales generated in Europe, the Middle East, and Africa (EMEA) in 2021, 18% in North Asia, 12% in South Asia Pacific, 12% in North America, and 8% in South America. Akzo is publicly listed and its market capitalization was about €12.5 billion in mid-November 2022.

Our Base-Case Scenario

Assumptions

- Eurozone GDP expands 3.1% in 2022, 0.3% in 2023, and 1.8% in 2024; U.S. GDP expands 1.6% in 2022, 0.2% in 2023, and 1.6% in 2024; China GDP expands 2.7% in 2022, 4.7% in 2023, and 4.8% in 2024.
- Brent crude prices of $100 per barrel for the remainder of 2022, $90 per barrel in 2023, and $80 per barrel in 2024.
- Revenue increases 14%-16% to €10.9 billion-€11.1 billion in 2022 from €9.6 billon in 2021, mainly resulting from substantial price increases in an inflationary environment, and, to a smaller extent, from M&A and positive foreign exchange effects. We expect that pricing initiatives will fully cover material cost inflation.
- Volumes decline 7%-9% in 2022, mainly due to destocking across distribution channels, especially in decorative paints in Europe, and COVID-19 restrictions in China. Furthermore, volumes were affected by supply constraints, especially in North America. We estimate the weakening demand trend will continue into 2023, resulting in a mid-to-high single digit volume decrease.
- A nearly 20% decline in S&P Global Ratings-adjusted EBITDA to €1.15 billion-€1.20 billion in 2022 from €1.47 billion in 2021, mainly spurred by lower volumes and higher input costs. We expect adjusted EBITDA to improve to €1.49 billon-€1.55 billion in 2023, supported by maintained pricing discipline, declining raw material costs, and various measures taken to reduce operating expenses.
- Capex of below €300 million in 2022-2023.
- Working capital outflows of €500 million-€600 million in 2022, turning to a reversal of €300 million-€500 million in 2023, depending on volumes and reductions in raw material prices.
- Dividends of about €365 million in 2022, which we expect to remain stable in 2023.
- No share buybacks in 2023.
- About €530 million of cash acquisition payouts in 2022, mainly for the Grupo Orbis deal completed in March, followed by a cash outflow of similar amount in 2023 for Kansai's activities in Africa. No other M&A is expected for 2023.

Key metrics

- Adjusted FFO to debt of 22%-26% in 2022, gradually recovering to 34%-38% in 2023, and above 45% in 2024;
- Adjusted debt to EBITDA of 3.1x-3.3x in 2022, reducing to 2.1x-2.3x in 2023, and further to clearly below 2.0x in 2024; and
- Annual FOCF of €50 million-€100 million in 2022, strengthening to above €1 billion in 2023.

Liquidity

The short-term rating on Akzo is 'A-2'. We view Akzo's liquidity as adequate because we forecast its sources to uses at above 1.3x over the next 12 months from Oct. 1, 2022. The assessment has temporarily weakened to adequate from strong due to high short-term debt used to finance working capital swings, share buybacks, and M&A, which will be repaid in the next 12 months. We note that Akzo's financial debt is not subject to any financial covenants.

Principle liquidity sources in the 12 months from Oct. 1, 2022, include:

- Reported cash and short-term investments of nearly €1.4 billion at Sept. 30, 2022.
- An undrawn committed revolving credit facility (RCF) of €1.3 billion due in 2027, which is not subject to any maintenance financial covenants.
- Cash FFO of €1.0 billion-€1.2 billion.
- Working capital releases of €300 million-€500 million, mainly driven by lower inventory.

Principle liquidity uses in the same period include:

- Short-term maturities of nearly €2 billion.
- Capex of below €300 million.
- Stable dividends at about €365 million.
- A payout for the acquisition of Kansai's business in Africa.

Environmental, Social, And Governance

ESG credit indicators: E-2, S-2, G-2

ESG factors have an overall neutral influence on our credit rating analysis of Akzo. As a leading specialty chemicals producer focusing on paints and coatings, it has lower energy intensity and greenhouse gas emissions compared to the industry average. In 2021, its scope 1 and 2 emissions amounted to about 20.9 tons of carbon dioxide per million U.S. dollars in revenue. In addition, it has already made substantial progress in transitioning to renewable energy, with more than than 45% of its electricity needs met by renewables in 2021 and 100% in Europe achieved in early 2022. The company is also developing more sustainable products. Its sustainable solutions have better environmental characteristics than mainstream offerings and accounted for more than 39% of sales in 2021. Akzo is the first paints and coatings company to receive the approval from Science Based Targets Initiative for its carbon reduction target including scope 3--50% less carbon emissions in the full value chain by 2030.

Issue Ratings - Subordination Risk Analysis

Capital structure

At Sep. 30, 2022, total financial debt stood at approximately €5 billion without lease liabilities, with the majority being euro bonds due between 2024 and 2030, followed by commercial paper and bank loans, all unsecured. Akzo's liquidity is supported by the undrawn €1.3 billion committed RCF.

Analytical conclusions

We rate Akzo's senior unsecured notes 'BBB', in line with the issuer credit rating, since we view subordination risk as limited in its capital structure.

Ratings Score Snapshot

Issuer Credit Rating	**BBB/Stable/A-2**
Business risk:	Satisfactory
Country risk	Intermediate
Industry risk	Low
Competitive position	Satisfactory
Financial risk:	Intermediate
Cash flow/leverage	Intermediate
Anchor	bbb
Modifiers:	
Diversification/Portfolio effect	Neutral (no impact)
Capital structure	Neutral (no impact)
Financial policy	Neutral (no impact)
Liquidity	Adequate (no impact)
Management and governance	Satisfactory (no impact)
Comparable rating analysis	Neutral (no impact)

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings, April 7, 2017
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013

- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Ratings List

Downgraded

	To	From
Akzo Nobel N.V.		
Issuer Credit Rating	BBB/Stable/A-2	BBB+/Stable/A-2
Senior Unsecured	BBB	BBB+
Ratings Affirmed		
Commercial Paper	A-2	