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Research Update:

Paints/Coatings Producer Akzo Nobel Outlook Revised To Negative On Sluggish Deleveraging; 'BBB' Ratings Affirmed

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PRIMARY CREDIT ANALYST

Wen Li
Frankfurt
+ 49 69 33999 101
wen.li
@spglobal.com

SECONDARY CONTACT

Oliver Kroemker
Frankfurt
+ 49 693 399 9160
oliver.kroemker
@spglobal.com

Rating Action Overview

- Soft demand and higher operating costs, including temporarily high restructuring costs, are weighing on Akzo Nobel N.V.'s EBITDA, leading to much slower-than-expected deleveraging and minimal rating headroom for 2024 and 2025, as reflected in S&P Global Ratings-adjusted funds from operations (FFO) to debt remaining below 30% in both years.
- However, a gradual improvement in market demand and the ramp-up of benefits from various cost saving measures will accelerate EBITDA growth and strengthen leverage to comfortably above 30% FFO to debt in 2026.
- We therefore affirmed our 'BBB/A-2' ratings on Akzo Nobel and its rated debt and revised the outlook to negative from stable.
- The negative outlook indicates that we could lower the ratings in the next 12-18 months if EBITDA growth and deleveraging were to significantly fall short of our base-case assumptions so that S&P Global Ratings-adjusted FFO to debt fails to demonstrate a clear path of recovery to exceed 30% by 2026 at the latest.

Rating Action Rationale

Akzo's leverage will remain elevated in 2024-2025, with S&P Global Ratings-adjusted FFO to debt below the minimum of 30% we view as commensurate with the 'BBB' rating, indicating minimal rating headroom. Despite a gradual improvement in gross margin, Akzo's deleveraging has lagged our expectation and we have revised down our base case several times since 2023. We now forecast S&P Global Ratings-adjusted funds from operations (FFO) to debt will reach 24%-26% in 2024 (versus 26%-28% in our previous forecast), then rise to 27%-30% in 2025 (versus 30%-33% in our last forecast), from 24.9% in 2023. This indicates minimal rating headroom under the 30%-45% range commensurate with the rating.

The delay in deleveraging is mainly driven by a sluggish recovery in EBITDA under challenging market conditions, accompanied by increased operating expenses and temporarily high restructuring costs. Given softer-than-expected volume growth, especially in Deco Paints, and higher operating expenses due to wage inflation and some inefficiencies in 2024, Akzo further narrowed its full-year adjusted EBITDA guidance for 2024 to about €1.5 billion as of end-October. We understand that the company is expecting a modest and gradual improvement in organic volume growth and easing pricing pressure in Deco Paints in China in 2025. It also plans to implement further price increases in some regions in 2025 in an inflationary environment.

Moreover, it is tackling its cost base by accelerating its industrial efficiency measures with the closure of three sites on track for year-end 2024 and further measures to be announced early 2025. This is the main driver for about €150 million of one-off costs in 2024 as guided by the company, weighing on our adjusted EBITDA. In addition, Akzo is also taking determined actions to reduce fixed costs through 2,000 job cuts globally with a focus on functions, which will be largely completed by first-quarter 2025. This will lead to one-off implementation costs of €100 million-€130 million, mostly to occur in 2025. As a result, we expect total one-off expenses to be still high in 2025--partly offsetting organic EBITDA growth--before falling significantly in 2026. Accordingly, we expect our adjusted EBITDA to slightly decrease to €1.36 billon-€1.40 billion in 2024 and rise again to €1.40 billion-€1.45 billion in 2025, from €1.42 billion in 2023 (after one-off items related to cost-saving measures, among others).

Gradual improvement in market demand and the ramp-up of benefits from implemented cost saving measures will accelerate EBITDA growth, improving leverage to comfortably above 30% FFO to debt in 2026. Akzo has reaffirmed the benefits of its industrial efficiency measures, which will be more than €25 million in 2024, up to €70 million in 2025, and more than €250 million by 2027. It also targets €120 million-€150 million of annualized savings from the 2,000 job cuts, with the full run rate to be realized by year-end 2025. The continuous ramp-up of various cost-saving measures, together with a gradual improvement in overall demand and market conditions, especially from higher growth in the coatings business, should lead to a material increase in our adjusted EBITDA to €1.60 billion-€1.65 billion and accelerated deleveraging to 34%-37% in 2026. This will represent a considerable improvement in rating headroom.

Akzo's solid free cash flow benefits from its relatively low capital intensity, however, it still needs to deliver working capital optimization. Lower-than-expected sales volumes, especially in Deco China, led to elevated inventory level as of September 2024, with working capital outflows at €424 million in the first nine months. We understand that Akzo is committed to reducing inventory as fast as possible and to continuously optimizing its working capital efficiency, targeting a net-working-capital-to-sales ratio of about 15% at the end of 2024 and about 13% in 2025-2026, down from 17.7% as of September. This will translate to total working capital outflow of about €150 million in 2024, which will improve to about neutral in 2025. In addition, the business' low capital expenditure (capex) requirements (3.0%-3.2% of sales) will continue to support solid free operating cash flow (FOCF). As a result, we forecast FOCF of €500 million-€550 million in 2024, increasing to €600 million-€700 million in 2025.

Our rating on Akzo is underpinned by its prudent financial policy. We expect Akzo to focus on margin improvement and deleveraging by improving its operational efficiency and optimizing working capital. We understand that management is committed to the 'BBB' rating and is keen to reduce its reported leverage to about 2.0x net debt to EBITDA in the medium term from about 2.7x expected by company for the end of 2024. Before the company achieves this leverage target, we expect to see disciplined capex and limited mergers and acquisitions (M&A), with the latter, if any, being financed by asset disposal proceeds. Akzo is shifting its capital allocation to key coatings markets in which it is trying to reach a sufficient scale to allow profitable growth. It has recently launched a portfolio review with an initial focus on Deco South Asia, especially in India, where it is difficult for Akzo to achieve a leading market position. The strategic options include a disposal and the creation of a joint venture. We also assume flat dividends and no share buyback in the next one to two years, reflecting our expectation that shareholder remuneration is not likely to affect Akzo's path to achieve its net leverage target. However, we note some pressure from shareholders who are pushing for share buybacks, given currently low share prices.

Outlook

The negative outlook reflects the risk that we could lower the rating in the next 12-18 months if EBITDA growth and deleveraging were to significantly fall short of our base-case assumptions.

Downside scenario

We expect Akzo's FFO to debt to continuously strengthen toward 30% by 2025 and exceed 30% in 2026. We could lower the rating if FFO to debt appears to be diverting from this path in the next 12-18 months. This could stem from prolonged weak market conditions, such as an absence of marked recovery in deco paints market in China, or subdued demand in automotive or other main industrial end markets. It could also be caused by setbacks in implementing cost saving and working capital improvement measures with a significant overrun in restructuring costs. A less supportive financial policy, although not assumed, could also increase negative pressure on the rating, for example, through the resumption of large M&A and share buybacks which lead to a delay in deleveraging.

Upside scenario

A recovery in S&P Global Ratings-adjusted FFO to debt to above 30% could prompt an outlook revision to stable. This would require a smooth execution of various measures to cut costs and reduce working capital. It will also depend on the pace of market recovery, as well as elements of the financial policy, such as well-controlled investments and shareholder distribution.

Company Description

Headquartered in the Netherlands, Akzo is a global leading producer of decorative paints (about 40% of group EBITDA in 2023) and performance coatings (about 60%). In 2023, it generated total sales of €10.67 billion and adjusted EBITDA of €1.42 billion. Akzo derives about 40.3% of its revenue from decorative paints, 19.5% from industrial coatings, 13% from powder coatings, 13.3% from auto and specialty coatings, and 13.9% from marine and protective coatings. The company has a global footprint with 47% of sales generated in EMEA in 2023, 16% in North Asia, 12% in South Asia Pacific, 13% in North America, and 12% in Latin America. Akzo is publicly listed with a market capitalization of about €10 billion as of early November 2024.

Our Base-Case Scenario

Assumptions

- Eurozone GDP expands modestly by 0.8% in 2024, 1.3% in 2025, and 1.4% in 2026; U.S. GDP expands 2.7% in 2024, slowing down to 1.8% in 2025, and 1.9% in 2026; China GDP expands 4.6% in 2024, 4.3% in 2025, and 4.5% in 2026.
- Revenue slightly down to €10.5 billion-€10.8 billion in 2024 from €10.8 billion in 2023, mainly resulting from flat to modest volume growth and price/mix effects, and negative foreign exchange effects. We expect 3%-4% sales growth in 2025-2026, reflecting higher prices in an inflationary environment and modest volume growth.
- S&P Global Ratings-adjusted EBITDA slightly down to €1.35 billion-€1.40 billion in 2024 from €1.42 billion in 2023, mainly spurred by soft volumes, higher operating expenses, especially labor costs and higher costs related to industrial efficiency measures. We expect adjusted EBITDA to modestly improve to €1.40 billon-€1.45 billion in 2025 after higher one-off items (mainly costs to implement job cuts), and significantly up to €1.60 billion-€1.65 billion in 2026 with market conditions gradually improving and benefits from cost saving measures ramping up.
- Capex of about €320 million in 2024, slightly up to about €350 million in 2025-2026, partly driven by incremental capex related to the industrial efficiency program.
- Neutral working capital outflow in 2025-2026, following about €150 million consumption in 2024, reflecting Akzo's commitment to reducing the current elevated inventory level and its target to bring down net working capital to about 15% of group revenue by end of 2024 and further down to about 13% in 2025-2026.
- Flat dividends of about €370 million in 2024-2025.
- No share buyback in the forecast period.
- No net cash outflow for M&A, which, if any, will be financed by proceeds from asset disposals.

Key metrics

- Adjusted FFO to debt of 24%-26% in 2024, up to 27%-30% in 2025 and further up to 34%-37% in 2026;
- Adjusted debt to EBITDA of about 2.7x in 2024, down to 2.3x-2.5x in 2025 and below 2.0x in 2026;
- FOCF of about €500 million-€550 million in 2024, rising to €600 million-€800 million in 2025-2026.

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 1.2x over the 12 months from Oct. 1, 2024. The assessment reflects high short-term debt maturities, including commercial paper, short-term loans, and a €500 million bond due in November 2024. The 2024 bond has been redeemed through the issuance of €500 million 10-year euro medium-term notes back in September. We expect a large portion of the nearly €900 million short-term loan to be refinanced and a smaller portion to be repaid. We note that Akzo's financial debt is not subject to any financial covenants.

Principal liquidity sources in the 12 months from Oct. 1, 2024, include:

- Reported cash and short-term investments of nearly €1.96 billion on Sept. 30, 2024, of which we view about €60 million as restricted.
- An undrawn committed revolving credit facility of €1.3 billion due in 2027, which is not subject to any maintenance financial covenants.
- Cash FFO of €0.9 billion-€1.1 billion.

Principal liquidity uses in the same period include:

- Short-term maturities of nearly €2.4 billion.
- Capex of €320 million-€350 million.
- Annual working capital outflow of less than €50 million; intrayear working capital swing of about €200 million.
- Stable dividends at about €370 million.

Ratings Score Snapshot

Issuer Credit Rating	**BBB/Negative/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	Neutral (no impact)
Comparable rating analysis	Neutral (no impact)
Stand-alone credit profile:	bbb

Related Criteria

- Criteria | Corporates | General: Sector-Specific Corporate Methodology, April 4, 2024
- Criteria | Corporates | General: Corporate Methodology, Jan. 7, 2024
- Criteria | Corporates | General: Methodology: Management And Governance Credit Factors For Corporate Entities, Jan. 7, 2024
- 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: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

Related Research

- EMEA Sector Update: Chemicals, Oct. 16, 2024
- Tear Sheet: Akzo Nobel N.V., Aug. 8, 2024

Ratings List

Outlook Action; Ratings Affirmed

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