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Ratings

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Research Update:

Akzo Nobel Rating Lowered To 'BBB+' On Disposal Of Specialty Chemicals Business; Outlook Stable

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Table Of Contents

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Overview

- Following the disposal of its specialty chemicals business to the private equity firm Carlyle and sovereign wealth fund GIC Private Ltd., in our view Akzo's business has reduced in size and scope, even though the company maintains leading global positions in its chosen markets.
- That said, factoring in the return to shareholders of an additional €5.5 billion, out of €7.5 billion in net proceeds from the disposal over 2019-2020, Akzo will have no adjusted debt under our base-case scenario and considerable headroom under the current rating.
- We understand that Akzo's financial policy remains committed to a 'BBB+' rating.
- We are therefore lowering our long-term rating on Akzo to 'BBB+'. We are affirming the short-term ratings at 'A-2'.
- The stable outlook reflects our view that Akzo's focus on operating efficiencies and cost pass-through will support adjusted EBITDA growth to about €1.3 billion-€1.4 billion in 2019, up from about €1.2 billion we estimate in 2018. We consider a ratio of funds from operations (FFO) to debt of about 45%-60% as commensurate with the 'BBB+' rating.

Rating Action

On Oct. 2, 2018, S&P Global Ratings lowered to 'BBB+' from 'A-' its long-term issuer credit rating on Netherlands-headquartered manufacturer of paints and coatings Akzo Nobel N.V. and revised the outlook to stable from negative. We affirmed the short-term rating on Akzo Nobel at 'A-2'.

At the same time, we lowered to 'BBB+' from 'A-' our issue ratings on Akzo's revolving credit facility (RCF), euro medium-term note program, and senior unsecured debt.

Rationale

The rating action follows the Oct. 1, 2018 announcement that the sale of Akzo's specialty chemicals business to private equity firm Carlyle and sovereign wealth fund GIC Private Ltd. has been completed, and the announcement earlier today that Akzo will return €5.5 billion of the €7.5

billion in net proceeds to shareholders. This is in addition to €1 billion already distributed in 2017 as a special dividend.

The sale delivers on Akzo's alternative strategy to accelerate value creation for shareholders, announced on April 19, 2017, which envisaged the sale of the specialty chemicals business to allow for undivided focus on the company's core paints and coatings businesses, where it commands leading global market positions. Following the disposal, Akzo will operate across two divisions:

- Performance coatings (60% of 2017 sales). Akzo is a leading supplier of performance coatings, with a strong product portfolio serving transportation, buildings and infrastructure, consumer goods, and industrial end-markets. The company holds No. 1 market positions in coil, marine, powder, protective, yacht, specialty plastic coatings, and wood finishes. Innovation, sustainability, and adherence to specific needs of the clients are key in this B2B model.
- Decorative Paints (40% of 2017 sales). Akzo is a leading global supplier of decorative paints, with No. 1 market positions in EMEA and Latin America, underpinned by well-recognized household brands. Products include paints, lacquers, varnishes, and specialty coatings for metals and wood. End-markets include cyclical buildings and infrastructure industries and the company serves both consumers and professional painters. Key distribution channels are often large-scale retailers such as Leroy Merlin, Kingfisher, and Bricomarche.

Notwithstanding leading market positions in the chosen segments, we view Akzo's business following the sale of higher margin specialty chemicals business as reduced in size and scope, and attaining lower margins than before the disposal. In 2017, its specialty chemicals business (now rated as Starfruit Topco Cooperatief U.A.) contributed about €914 million in reported EBITDA on a margin of 18.4%. Furthermore, Akzo's adjusted EBITDA margin for the continuing operations of about 13% in 2017 is at the lower end of the 12%-20% range we consider average for specialty chemicals companies. Profitability is also lower than that of its main peers PPG, Sherwin-Williams, and Axalta, which--albeit with a different product mix--on average achieved S&P Global Ratings-adjusted EBITDA margins of about 18%-19% in 2017. As such, we have revised our assessment of Akzo's business risk profile to satisfactory (higher end) from strong.

We understand that management is strongly committed to improving margins through several operating efficiency initiatives across the organization and its functions, targeting return on sales of 15% and return on investment of more than 25% by 2020, up from 9.4% and 13.9% in 2017.

Under our base-case forecast, Akzo will have no adjusted debt in 2018 and 2019, and will generate positive free operating cash flow (FOCF) of about €0.2 billion-€0.3 billion in 2018 and about €0.5 billion in 2019. The lack of leverage factors in the return over 2019-2020 of €5.5 billion to shareholders by way of €1 billion special dividend and €2 billion capital reduction and share consolidation (the latter subject to shareholders' approval), both in

2019, as well as €2.5 billion share buyback program, which will be likely completed during the middle of 2020. Akzo intends to use the retained €1 billion for debt reduction, costs associated with the transformation, and bolt-on acquisitions.

We understand that Akzo's strategy is to grow organically and by bolt-on acquisitions, with no transformative transactions planned. We see this as the main risk to our base-case scenario in light of the consolidation of the industry and Akzo's clear appetite for larger deals evidenced by discussions regarding a potential merger with Axalta back in October 2017, which ended without an agreement. We understand that there are no large transactions planned at present.

In our base-case for 2018-2019, we assume:

- Revenue decline on like-for-like basis of about 3%-4% in 2018, and about 2%-3% growth in 2019. The assumption for 2018 reflects pressure from the volume and foreign exchange observed in the first half of 2018, which were not fully offset by Akzo's pricing initiatives, followed by moderate growth in prices and volumes in 2019.
- Adjusted EBITDA margin about 13% in 2018 (stable year-on-year in comparison with 2017) and 14%-15% in 2019, factoring in both the implementation cost and benefits of Akzo's comprehensive efficiency program with particular focus on service excellence, collaboration with customers, digitalization, inventory management, asset optimization, and other. We note that in the first half of 2018 the company's margins were challenged by the rising cost of raw materials, as well as costs related to the restructuring activities.
- Capex at a normalized level of about 3% of sales.
- Working capital outflows of about €100 million in both years.
- Ordinary dividends at about €1.65 per share, increasing in line with stable to progressive policy.
- Bolt-on acquisitions up to €200 million.
- No transformational acquisitions.
- About €7.5 billion in net proceeds from the sale of specialty chemicals business in 2018, which will be used for the financing of:
- --€1 billion of special dividend in 2019,
- --€2 billion of capital reduction combined with share consolidation in 2019, and
- --€2.5 billion of share buybacks, spread between 2019-2020.

Based on these assumptions, we arrive at the following measures:

- Adjusted EBITDA of about €1.1 billion-€1.2 billion in 2018 and about €1.3 billion-€1.4 billion in 2019.
- Adjusted FFO to debt and debt to EBITDA ratios at nil, reflecting no

adjusted debt.

- Positive FOCF of €0.3 billion-€0.4 billion in 2018 and about €0.5 billion in 2019.

Considering the above strong measures, we revised our assessment of Akzo's financial risk profile to minimal from modest.

We believe that Akzo's financial policy provides for maintaining a 'BBB+' rating, therefore, our assessment of the company's financial policy does not support raising the rating at this time. That said, we recognize the company's track record of prudent risk management and a considerable headroom given no adjusted debt at present.

Liquidity

We view Akzo's liquidity as strong because we forecast its ratio of liquidity sources to uses at above 1.5x over the next 12 months and above 1.0x over the subsequent 12 months.

Principal liquidity sources in the next 12 months include:

- Reported cash of about €0.6 billion at June 30, 2018. We treat about €0.4 billion of this balance as not available for immediate debt reduction.
- Undrawn committed RCF of €1.8 billion due in 2022, which is not subject to any maintenance financial covenants.
- Cash FFO of about €0.8 billion.
- Net proceeds from the sale of specialty chemicals business of €7.5 billion.

Principal liquidity uses include:

- Short-term debt of about €1.6 billion.
- Capital expenditure at about 3% of sales.
- Normalized seasonal working capital outflows of €0.3 billion-€0.4 billion in the first half of the year, and inflows in the second half of the year.
- Bolt-on acquisitions up to €200 million.
- Ordinary dividends at about €1.65 per share, increasing in line with stable to progressive policy.
- A special dividend of €1 billion in 2019.
- Capital reduction combined with share consolidation of about €2 billion executed in 2019, and share repurchases of about €2.5 billion (conducted over 2019-2020).

Outlook

The stable outlook reflects our view that Akzo's focus on operating efficiencies and costs pass through will support the growth in its adjusted EBITDA to about €1.3 billion-€1.4 billion in 2019, up from about €1.2 billion in 2018. We consider a ratio of FFO to debt of about 45%-60% as commensurate with the 'BBB+' rating.

Downside scenario

We see the likelihood of a downgrade as low, reflecting generous headroom in the rating. However, we could lower the rating if Akzo's growth strategy results in sizable, debt financed acquisitions, even though we would weigh such transaction against corresponding benefits to the business. Higher-than-anticipated dividends, share buybacks, or marked deterioration in the operating performance resulting in sustained FFO to debt ratio below 45% could also lead to a negative rating action.

Upside scenario

We could raise the rating on Akzo if its financial policy supported a higher rating, notably through the commitment to prudent outlays for acquisitions and shareholder remunerations, and adherence to adjusted FFO to debt ratio of at least 60%. A revision of our assessment of Akzo's business, for example if it were to clearly and sustainably narrow the profitability gap with peers, could also lead to positive rating pressure.

Ratings Score Snapshot

Issuer Credit Rating: BBB+/Stable/A-2

Business risk: Satisfactory
- Country risk: Intermediate Risk
- Industry risk: Low Risk
- Competitive position: Satisfactory

Financial risk: Minimal
- Cash flow/Leverage: Minimal

Anchor: a

Modifiers
- Diversification/Portfolio effect: Neutral (no impact)
- Capital structure: Neutral (no impact)
- Financial policy: Negative (-2 notches)

- Liquidity: Strong (no impact)
- Management and governance: Satisfactory (no impact)
- Comparable rating analysis: Neutral (no impact)

Issue Ratings--Subordination Risk Analysis

Capital structure

At Dec. 31, 2017, Akzo's capital structure consisted primarily of €750 million 2.625% senior unsecured bond due 2022, €500 million 1.75% senior unsecured bond due 2024, €500 million 1.75% senior unsecured bond due 2026, €500 million floating rate senior unsecured bond due 2019, and €800 million 4% senior secured bond due 2018. Akzo's liquidity is supported by the undrawn €1.8 billion committed RCF due in 2022. Akzo's debt is rated 'BBB+', the same as the issuer credit rating, because in our view subordination risk is not significant in its capital structure.

Related Criteria

- 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
- Criteria - Corporates - Industrials: Key Credit Factors For The Specialty Chemicals Industry, Dec. 31, 2013
- General Criteria: Group Rating Methodology, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology: Ratios And Adjustments, Nov. 19, 2013
- Criteria - Corporates - General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Country Risk Assessment Methodology And Assumptions, Nov. 19, 2013
- General Criteria: Methodology: Industry Risk, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities And Insurers, Nov. 13, 2012
- General Criteria: Use Of CreditWatch And Outlooks, Sept. 14, 2009

Ratings List

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Downgraded; Outlook Action; Ratings Affirmed
                                        To                 From
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Akzo Nobel N.V.		
Issuer Credit Rating	BBB+/Stable/A-2	A-/Negative/A-2
Senior Unsecured	BBB+	A-
Commercial Paper	A-2	A-2
Akzo Nobel Sweden Finance AB (publ)		
Senior Unsecured	BBB+	A-

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following S&P Global Ratings numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.