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Research Update:

Akzo Nobel Outlook Negative On Ongoing Uncertainty Of Potential Corporate Actions; 'A-' Rating Affirmed

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Overview

- Akzo Nobel remains committed to separating its paints and coatings and specialty chemicals businesses by April 2018 and returning the vast majority of the net proceeds to shareholders.
- We now see a potentially longer timeframe for the resolution of the corporate actions Akzo is considering.
- We are affirming our 'A-' corporate credit rating on Akzo and removing the rating from CreditWatch with negative implications.
- Our negative outlook captures the uncertainty around whether Akzo decides to spin off or demerge its specialty chemicals business, and ultimately what the leverage of Akzo's paints and coatings business will be.
- We could lower the rating by one notch depending on our view of Akzo's leverage and strategic direction. If Akzo's leverage is higher than we anticipate currently, we could lower the rating by two notches.
- We note the new management's commitment to a strong 'BBB+' rating for the paints and coatings business.

Rating Action

On Oct. 20, 2017, S&P Global Ratings affirmed its 'A-' long-term issuer credit rating on Netherlands-based manufacturer of paints, coatings, and speciality chemicals Akzo Nobel N.V. and removed the rating from CreditWatch with negative implications, where it was placed on May 5, 2017 (see "Akzo Nobel Ratings Placed On CreditWatch Negative On Potential Corporate Actions," published on RatingsDirect). The outlook is negative. We affirmed the short-term rating on Akzo Nobel at 'A-2'.

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

Rationale

The rating action reflects the uncertainty around Akzo's leverage and strategic direction, if and when the specialty chemicals business is separated, as well as the time needed by the company to consider all available options. We note that the current management team (following the departure of the CEO Ton Buchner and CFO Maelys Castella, both for health reasons) is fully committed to the execution of the separation process, as well as to achieving

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growth and profitability targets set out by Akzo in its strategy update on April 19, 2017.

We understand that Akzo intends to return the vast majority of the net proceeds from the disposal of its specialty chemicals business to shareholders. At the same time, we recognize the new management's financial policy commitment to a strong 'BBB+' rating for the paints and coatings business and 'BBB' category creditworthiness for the specialty chemicals business.

Our assessment of the future credit quality of the company would continue to incorporate Akzo's strong market positions in paints and coatings industries across major regions. After the separation, Akzo will continue to be well-diversified, with a presence in mature European markets (33% of 2016 sales), Asia-Pacific (33%), North America (13%), and emerging European markets (8%). We also believe that the paints and coatings business will continue generating stable and strong cash flows that are more than sufficient to cover modest capital expenditure (capex) at about 3% of sales and dividends of about €0.3 billion (similar to historical levels).

These strengths would be weighed against our view that the disposal of Akzo's specialty chemicals business (40% of 2016 EBITDA, with a margin of about 20%) will decrease diversity from Akzo's product portfolio, therefore reducing the company's overall size and scope.

We recognize Akzo's ongoing focus on costs and passing through higher raw-materials prices to customers, as well as the potential additional financial flexibility of about €2.4 billion offered by sale proceeds to support credit ratios. However, we consider that the paints and coatings business may exhibit more volatile profitability than Akzo before the separation due to its somewhat longer lag in the pass-through of raw-materials prices.

According to management, the creation of two fully separate business units will allow for a more focused growth strategy, clearer customer focus, and additional cost efficiencies of €150 million per year from continuous improvement and about €110 million per year from 2018, stemming from integration of the supply chain and better leveraging of the support functions. These would allow Akzo to target an EBIT margin of 15% for paints and coatings and 16% for specialty chemicals by 2020. In our view, while Akzo has an extensive track record of restructuring, the new targets will require a thorough cost review in the organization, and may be challenging to achieve in an inflationary cost environment. We also note Akzo's guidance that EBIT for 2017 will now be in line with 2016, due to industry headwinds.

In our base-case (under the current business perimeter), we assume:

- Revenue growth of about 2%-3% in 2017, hampered primarily by unfavorable currency effects so far this year, but partly offset by volume growth mainly from decorative paints.
- Reported EBITDA margins (after restructuring) of about 14.5%-15% in 2017

and 14%-15% in 2018. This assumption balances ongoing operating efficiency improvements with potential restructuring costs related to the separation, as well as pressure from higher costs of raw materials.
- In 2017, a decrease in the International Financial Reporting Standards (IFRS) pension deficit, reflecting higher discount rates, lower inflation, and pension top-up payments of €273 million, partly offset by lower returns from pension assets and cost of de-risking of pension liabilities. Going forward, we assume significantly lower volatility of the U.K. pension fund following Akzo's extensive derisking program. That said, changes in actuarial assumptions--notably discount rates--could still have a negative effect on the overall deficit.
- Capex at about 4% of sales.
- About a 50% increase in dividend to €2.50 per share in 2017, plus a special dividend as advance proceeds of €1 billion on Dec. 7, 2017.
- Neutral working capital at year-end.

Based on these assumptions, we arrive at the following:
- Reported EBITDA (after restructuring costs) of about €2.1 billion-€2.2 billion in 2017 and 2018.
- S&P Global Ratings-adjusted debt to EBITDA of 1.7x-1.9x in both years.
- Adjusted funds from operations (FFO) to debt of about 40% in 2017 and about 45% in 2018.

The above ratios, notably the adjusted FFO to debt ratio, are weaker compared to the 70%-75% for 2017 we anticipated in October 2016 when we raised the rating on Akzo to 'A-'. As a result, we have now revised the financial risk profile downward to modest from minimal. Our comparable rating analysis constrains the rating by one notch, reflecting our view that Akzo's profitability is lower than that of its immediate peers, notably PPG Industries and Sherwin-Williams. Having said that, we recognize a strong, and in our view largely sustainable, improvement in Akzo's margins.

Liquidity

We have revised Akzo's liquidity to strong from exceptional under our criteria, because we now forecast the ratio of sources to uses at above 1.5x over the next 12 months and above 1.0x over the subsequent 12-month period.

Principal liquidity sources include:
- Reported cash of about €0.6 billion at the end of Sept. 30, 2017. We treat €0.4 billion of this as not available for immediate debt reduction.
- Undrawn RCF of €1.8 billion due in 2022, which is not subject to any financial covenants.
- Cash FFO of about €1.4 billion-€1.5 billion.

Principal liquidity uses include:
- Short-term debt of about €0.1 billion as of Sept. 30, 2017.
- Capital expenditure at about 4% of sales.
- Seasonal working capital outflows of €0.5 billion-€0.6 billion in the first half of the year, and inflows in the second half of the year, as in

the past.

- Dividend payments (including to minority shareholders) of about €0.6 billion, plus a special dividend of €1 billion to be paid in December 2017.

Outlook

Our negative outlook captures the uncertainty around whether Akzo decides to spin off, demerge, or take public its specialty chemicals business, as well as the size of disposal proceeds and ultimately the leverage of Akzo's paints and coatings business.

Downside scenario

We could lower the rating by one notch, depending on our view of the leverage and strategic direction of Akzo after the separation, as well as our assessment of its business risk profile following the separation. If Akzo's leverage is higher than we anticipate currently, we could lower the rating by two notches.

Upside scenario

We would revise the outlook back to stable if Akzo's separation of the paints and coatings and specialty chemicals businesses does not go through.

Ratings Score Snapshot

Issuer Credit Rating: A-/Negative/A-2

Business risk: Strong
Country risk: Intermediate
Industry risk: Low
Competitive position: Strong

Financial risk: Modest
Cash flow/Leverage: Modest

Anchor: a

Modifiers
Diversification/Portfolio effect: Neutral (no impact)
Capital structure: Neutral (no impact)
Financial policy: Neutral (no impact)
Liquidity: Strong (no impact)
Management and governance: Satisfactory (no impact)
Comparable rating analysis: Negative (-1 notch)

Issue Ratings

Capital structure

Akzo's capital structure consists of an €800 million bond due 2018, a €500 million bond due 2024, and a €500 million due 2016 issued by Akzo Nobel N.V., as well as €750 million notes due 2022 issued by Akzo Nobel Sweden Finance AB. All notes are senior unsecured. Liquidity is supported by a €1.8 billion senior unsecured multi-currency RCF due 2022, and a U.S. dollar and euro commercial paper program that can be used to the extent that the equivalent portion of the RCF is not used.

Analytical conclusions

With no material priority obligations ranking ahead of the company senior unsecured obligations, we rate its senior unsecured debt 'A-', the same as the corporate credit rating.

Related Criteria

- Criteria - Corporates - General: Reflecting Subordination Risk In Corporate Issue Ratings, Sept. 21, 2017
- 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

Ratings Affirmed; CreditWatch/Outlook Action

	To	From
Akzo Nobel N.V.		
Corporate Credit Rating	A-/Negative/A-2	A-/Watch Neg/A-2
Senior Unsecured	A-	A-/Watch Neg
Commercial Paper	A-2	A-2

Akzo Nobel Sweden Finance AB (publ)		
Senior Unsecured*	A-	A-/Watch Neg

*Guaranteed by Akzo Nobel N.V.

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