Akzo Nobel N.V.

PPG's third offer heightens credit risk relative to break-up plan

Akzo Nobel (Baa1 stable) has yet to respond to PPG Industries, Inc.’s (A3 negative) revised offer of €96.75 per share, which represents an increase of 17% from the first proposal to acquire the company for €83 in early March 2017, and a premium of over 50% over the pre-announcement closing price of €64 on 8 March 2017. Undoubtedly, this third improved offer puts additional pressure on the Dutch group’s management to engage with PPG and raises the probability that a deal eventually materialise, which may have negative rating implications for Akzo Nobel.

Equally, we believe that Akzo Nobel's strategic plan for the separation of its Specialty Chemicals business set out to fend off PPG's take-over bid, can be implemented within the Baa1 rating category targeted by the group.

In the short-term, Akzo Nobel's intention to return €1.6 billion to shareholders, through a €1 billion special dividend combined with a 50% increase in its regular dividend to €2.50 per share for 2017, will greatly reduce the headroom it currently enjoys within the Baa1 rating category. Based on management’s guidance of a year-on-year increase in EBIT of around €100 million to €1.6 billion, we anticipate that the group's retained cash flow (RCF) to net debt will decline to around 36% in 2017 against 49% in 2016 (assuming a scrip dividend take-up rate of 35%).

However, we believe that Akzo Nobel will have the flexibility to structure the separation of its Specialty Chemicals business in such a way that its financial profile remains commensurate with the Baa1 rating targeted by management, despite paying out around 50% of the net profit as dividends. We estimate that the Paints & Coatings business that is characterised by relatively low capital intensity, will generate free operating cash flow after capex of around €650-700 million in 2018, i.e. in excess of a dividend pay-out of €412 million (based a €1.65 per share on 250 million shares).

In 2016, the Specialty Chemicals business accounted for about 33% of group sales and generated a net cash flow of around €600 million, as measured by EBITDA minus capital expenditure. It has the debt servicing capacity to assume a sizeable amount of debt (and debt-like) obligations at the Baa2 rating level, which is targeted by management in the case of an IPO or spin-out. Alternatively, the sale of the business on a debt free basis will generate proceeds of €8-12 billion based on a range of valuation of 8-12x historical EBITDA. This would also allow Akzo Nobel to adjust its capital structure so to protect its Baa1 rating despite management’s commitment to return to shareholders the vast majority of the net sale proceeds.
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