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

- 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.

FRANKFURT (S&P Global Ratings) Nov. 13, 2024—S&P Global Ratings today took the rating actions listed above.

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.

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.

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.

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.

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.spglobal.com/ratings for further information. A description of each of S&P Global Ratings' rating categories is contained in "S&P Global Ratings Definitions" at https://disclosure.spglobal.com/ratings/en/regulatory/article/-/view/sourcel
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Disclosures include requirements relating to press releases or reports published in accordance with Article 10(1), 10(2), and 10(5), and Annex I,

Section D, I, 1, 2, 2a, 4, and 5. These requirements are available by rating via the link titled "Regulatory Disclosure" and include, but are not limited to:

- Key Elements Underlying The Credit Rating
- ESG Credit Factors
- Solicited Or Unsolicited Status
- Analysts Primarily Responsible For The Credit Rating
- Office Responsible For The Credit Rating
- Materials Used In The Credit Rating Process
- Criteria Applied
- Models Applied, Loss, And Cash Flow Analysis Performed
- Scenario Analysis
- Sensitivity Analysis
- Risk Warning, Understanding Credit Rating Categorizations, And Criteria
- Rated Entity Notification
- Ancillary And Additional Services
- Attributes And Limitations Of The Credit Rating
- Information Specific To Structured Finance And Securitization Instruments