Akzo Nobel NV
AKZA: XAMS (NLD)

View Stock Summary

Morningstar Rating for Stocks	Fair Value	Economic Moat	Capital Allocation
★★★★	€66.00	Narrow	Standard

AkzoNobel Navigates Challenging Operating Market, but Portfolio Review Could Bear Fruit

Spencer Liberman •
Jan 18, 2025

Share

Stock Analyst Note

AkzoNobel Earnings: Tepid Decorative Paint Demand Continues to Pressure Volume and Price Growth

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Jan 30, 2025

Stock Analyst Note

AkzoNobel: Portfolio Review Could Unlock Shareholder Value in Challenging Coatings Environment

Spencer Liberman •
Jan 18, 2025

Business Strategy and Outlook

AkzoNobel is the world’s third-largest producer of paints and coatings, operating with a substantial footprint across multiple continents. Its products are sold to a wide variety of end markets, including architectural, automotive, packaging, marine, and aerospace. Europe/Middle East/Africa represents the largest region for the company, accounting for almost half of sales. While AkzoNobel is one of the most diversified paint and coatings producers, it has somewhat focused its portfolio in recent years, exemplified by the sale of its specialty chemical business. Additionally, Akzo announced a portfolio review in 2024, which could include additional divestments or strategic alternatives for some of its noncore assets.

The company is divided into two segments: decorative paints (40% of sales) and performance coatings (60% of sales). Decorative paints are applied externally and internally to buildings and serve the do-it-yourself and professional painter end markets. While the US architectural market is highly concentrated, most other regions operate with a wide array of brands produced by a number of companies. After AkzoNobel sold its North American decorative business to PPG in 2013, its decorative paints segment mainly sells in EMEA, Latin America, and Asia.

The company's performance coatings are primarily functional products used in a variety of industrial end markets, including automotive, aerospace, oil and gas, marine, and packaging. AkzoNobel sells these products under many different brands that each serve specific end markets and product needs. In recent years, AkzoNobel has supplemented some growth with acquisitions, most recently acquiring Sherwin-Williams' Valspar Hong Kong business. The company also purchased Grupo Orbis in Colombia in 2022 as it builds its global coatings portfolio.

Bulls Say, Bears Say

Bulls

The company operates in a diverse range of end markets, leading to smoother earnings in times of industry-specific slowdowns.

The Dulux brand enjoys durable pricing power and usually holds a top-three position in its key markets.

AkzoNobel's portfolio review could unlock shareholder value as the company divests from noncore assets and invests in its highest-margin businesses.

Bears

The low-hanging fruit for cost savings has likely been harvested, raising concerns about AkzoNobel achieving further efficiencies and limiting margin expansion for the company.

AkzoNobel's performance coatings portfolio operates in highly competitive end markets that typically earn lower margins than architectural coatings.

Despite a diversified customer base and coatings portfolio, AkzoNobel's profitability is not immune from economic slowdowns, as seen in 2008 and 2009.

Financial Strength

We think AkzoNobel has a sound capital structure. Its consistent free cash flow generation should support its debt-service requirements and future capital-allocation decisions. After an increase in leverage in 2022, net debt/EBITDA rose above the target of 2 times, but management has reiterated its intention to lower debt. This will likely play out in the company's new portfolio review, which could result in divestitures or other strategic actions for noncore assets. The proceeds from these actions will likely be used to reduce leverage toward management's target. The company ended 2023 with net debt/EBITDA of roughly 2.7, higher than its historical average. AkzoNobel has roughly EUR 5.5 billion of outstanding debt but has ample liquidity, with over EUR 1.5 billion of cash and cash equivalents on hand. AkzoNobel has a history of strong free cash flow generation, and we expect it will maintain its sound capital structure.

Economic Moat

We think AkzoNobel benefits from durable competitive advantages that should support economic profits for at least the next 10 years. We assign it a narrow moat rating based on its intangible assets and switching costs. The company participates in most architectural paint markets while also selling into industrial end markets such as automotive, packaging, marine, aerospace, and general industrial. This diversity makes it hard for the company to materially underperform or outperform the broader coatings space, given the relatively small contribution each business makes on its own. AkzoNobel is the third-largest paint and coatings producer behind Sherwin-Williams and PPG. Roughly 47% of AkzoNobel's sales are in EMEA, where the company sells a wide array of decorative paints and performance coatings. The company's sales in Asia account for 28% of revenue while North America and Latin America make up the remaining 13% and 12% of revenue, respectively.

AkzoNobel sells its decorative paint products to architectural end markets, supplying both DIY consumers and professional painters with paints and coatings for indoor and outdoor applications. Its most popular brand, Dulux, has strong brand recognition in Europe and has a leading position in most markets where its sold. According to Euromonitor, AkzoNobel holds a top three market position in home paint in the regions it operates, with a number-one position in Western Europe and Latin America.

While we think AkzoNobel does not have the same brand strength as Sherwin-Williams in North America, we think its brands command enough pricing power to support an intangible asset moat source. The disparity in brand strength between AkzoNobel and its North America counterparts is due to market differences: Sherwin-Williams competes against a few rivals in a highly concentrated North American paint market while AkzoNobel competes against multiple rivals and brands that can differ across countries. Additionally, AkzoNobel does not operate a store network with similar density to that of Sherwin-Williams, which limits how much painters rely on its products when there are substitutes available at most stores.

Dulux is the leading home paint brand in Western Europe, with roughly 11% market share in 2023, according to Euromonitor. This is especially notable since the top five brands in the region accounted for less than 20% of the market. Dulux has over 3 times the market share of its next-closest competitor in the region. This is in stark contrast to North America, where five brands have over 70% market share and two of them are owned by Sherwin-Williams. This market concentration creates strong brand recognition and drives pricing power for the four large players as consumers and professional painters are willing to pay up for their preferred brand. This is especially prevalent among the professional painter community, where costs of paint are passed through to the customer and factors like quality, ease of use, and availability are very important. Nevertheless, we think Dulux enjoys strong brand recognition that drives pricing power for the firm.

In Western Europe, AkzoNobel and the other key players operate virtually no stores but rely instead on small- and large-scale home improvement outlets that sell a large assortment of paints. This differs greatly from North America, where Sherwin-Williams operates a network of over 5,000 company-owned stores that cater to professional painters. Additionally, PPG owns the Comex brand in Mexico, which has more than 4,000 stores in the country. Sherwin-Williams' extensive store network means that professional painters are never far from a store where they can purchase the same products they have relied on for years. While AkzoNobel does not operate a vast store network, it has a small store presence as it owns over 200 Dulux Decorator Centre stores throughout Great Britain.

Outside of North America, the decorative paint business is a local business, with regional differences in product assortment and distribution that have somewhat limited AkzoNobel's ability to harmonize its portfolio across different markets. In North America, the paint market is much more homogenous and concentrated, with the top four players commanding more than 70% of the market. The concentrated market share and limited number of brands results in superior brand awareness and creates strong customer loyalty that drives significant pricing power, especially for Sherwin-Williams as it's viewed as the premier paint for professional painters.

AkzoNobel's performance coatings business sells a wide range of coatings products that provide functionality when applied. This can vary by product type, but coatings can provide corrosion protection, fire protection, scratch resistance, and more. Its four primary end markets—powder coatings, marine and protective, automotive and specialty, and industrial coatings—each account for roughly one fourth of sales and contain multiple end markets and products. This diversity makes it hard for the company to materially underperform or outperform the broader coatings space, given the relatively small contribution each business makes on its own.

Many of the coatings are generally specialized, offering some form of functionality that can be critical to the product. Unlike the company's decorative paints business, performance coatings offer more than just aesthetic appeal. AkzoNobel's customers rely on the performance of its coatings products. In some instances, the coatings are specifically formulated to meet a customer's needs. These dynamics create a stickiness from AkzoNobel's customers that is not obtained in the architectural paint market.

Given that coating is generally embedded as a step within the broader production process, factors like dry time, cure time, and abrasion resistance can affect the pace or process throughout the remainder of assembly. Accordingly, a coating switch has costly implications for only marginal savings per unit. Many manufacturing facilities operate at high efficiencies to maintain output and margins. Downtime related to switching coatings and potentially replacing specialized equipment is a large deterrent for most companies.

Fair Value and Profit Drivers

Our fair value estimate is EUR 66 per share. We see solid growth and profitability for AkzoNobel over our 10-year forecast horizon, with consolidated sales growing at a 3.2% compound annual rate and adjusted operating margins averaging about 10.7% (compared with the 9.0% 10-year average). While we think AkzoNobel may be able to extract more value through its recently announced portfolio review, we think tepid end-market demand could offset some of the early gains experienced from the overhaul. Our stage two model assumptions assume AkzoNobel can increase earnings before interest at a 5% annual rate with an 18% investment rate for five years after our 10-year explicit forecast period.

AkzoNobel's exposure to a wide array of industrial end markets lowers the variance of the firm's overall growth. In its performance coatings business, AkzoNobel sells coatings to a wide array of end markets, including automotive, aerospace, oil and gas, marine, and packaging. While some end markets have faced headwinds in recent years, we expect the business will grow at GDP-like rates as weakness in some end markets is offset by strength in others. The performance coatings market is much more competitive than architectural, leading firms to compete more on price. This dynamic has led many large producers to pursue bolt-on acquisitions. The enables AkzoNobel and its competitors to more easily expand their product portfolios and exposure to certain regions.

The company's decorative paints business services both DIY and professional painters for architectural paint projects. DIY demand spiked in 2020 during the onset of the covid-19 pandemic, when many people were stuck in their homes and turned to painting projects. Additionally, many households hired professional painters to update their homes. Demand slowed in 2022 and 2023 as many consumers had completed projects and destocking headwinds began to mount. Demand has recovered in some markets like the UK, Latin America, and Southeast Asia but remains somewhat constrained in China and Central Europe. We expect solid growth for AkzoNobel's decorative coatings business as it continues to grow its Dulux brand and increases its focus on key markets. A continued recovery in demand should ease inventory buildup and enable the decorative paints business to expand margins over the next few years.

Price vs Fair Value

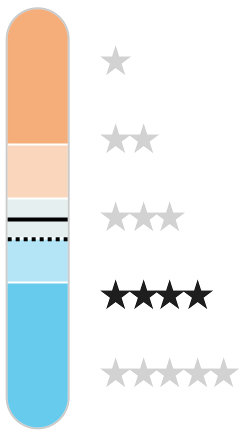
View History >

AKZA is trading at a 9% discount.

— Fair Value
€66.00
Jan 17, 2025

Uncertainty
Medium

····· Price
€59.84
Feb 17, 2025



1-Star Price	€89.10
5-Star Price	€46.20
Economic Moat	Narrow
Capital Allocation	Standard

Terms ⓘ

Risk and Uncertainty

We assign AkzoNobel a Medium Morningstar Uncertainty Rating. From a fundamental perspective, we believe a potential slowdown in global GDP growth elevates the company's risk profile. AkzoNobel has diverse geographic exposure and operates in a wide array of end markets, ranging from architectural to highly specialized industrial applications. Due to its exposure to industrial end markets, demand tends to grow near GDP-like rates. Coatings companies can experience considerable margin compression during a downturn, especially if the housing market weakens considerably, but also can benefit from times of strong economic growth. The company's profit margins are also affected by oil and titanium dioxide price volatility. Rising input costs can strain margins, and it can take time before the company can pass on commensurate price increases.

AkzoNobel is exposed to a couple of environmental, social, and governance risks, including environmental and social impact of its products and services and carbon emissions from its operations. However, we don't believe these risks could result in material value destruction. AkzoNobel has a history of developing environmentally friendly products and has expanded its portfolio of these products. Almost 40% of sales are generated from sustainable solutions, representing over EUR 4 billion of sales. The company has also made progress on many of its environmental initiatives, including reducing its carbon emissions by 38% since 2018 and now deriving roughly 62% of its electricity use from renewable sources. We expect the firm's product leadership and commitment to environmentally friendly products and lower carbon emissions will continue.

Capital Allocation

We assign AkzoNobel a Standard Capital Allocation Rating. This reflects our forward-looking assessments of the firm's financial health, investment strategy and efficacy (organic and inorganic), and shareholder distribution policy. Our Standard rating is a function of our sound balance sheet, satisfactory investment, and appropriate shareholder distribution ratings.

AkzoNobel's balance sheet is sound, in our view. We believe the company's leverage is reasonable considering its stable profitability and strong free cash flow generation. While leverage has increased in recent years, the company maintained net debt/EBITDA of 2.7 at the end of 2023, and management remains committed to maintaining an investment-grade debt rating and reducing leverage over the next few years.

We view AkzoNobel's investment strategy as satisfactory. Following PPG's failed acquisition in 2017, AkzoNobel worked quickly to improve its business. This began with the divestment of its specialty chemical business for EUR 10 billion in 2018. Since then, AkzoNobel has focused on improving the margins of its slimmer, coatings-focused portfolio while executing some bolt-on acquisitions. More recently, the company announced a strategic review of its portfolio; it intends to invest in its more favorable businesses while possibly divesting from some assets. As the company embarks on its portfolio review, the success of future investments, acquisitions, divestitures, and strategic reviews is uncertain, and a variety of factors could destroy shareholder value. Nevertheless, we expect AkzoNobel's returns on invested capital to sit well above its weighted average cost of capital.

We believe AkzoNobel's shareholder distributions are appropriate. AkzoNobel's policy is to pay a stable to rising dividend; the current dividend has been roughly flat for the past four years, largely due to stagnant profits following the covid-19 pandemic. Following the sale of its specialty chemical business, the company repurchased a sizable number of shares but has slowed buybacks since. We expect it will limit repurchases over the next few years as it invests in its business and shores up its balance sheet.