

Summary:

Akzo Nobel N.V.

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Credit Rating: BBB+/Stable/A-2

Rationale

The ratings on The Netherlands-based coatings and chemicals producer Akzo Nobel N.V. reflect what Standard & Poor's Ratings Services views as the company's "strong" business risk profile and "intermediate" financial risk profile.

Akzo's strong business risk profile benefits from a favorable business position and significantly lower cyclicality, relative to other chemicals companies. Akzo enjoys a worldwide leading position in decorative paints and performance coatings, which combined account for about two-thirds of group sales, complemented by midsize specialty chemical activities. The paints and coatings industry enjoys low capital intensity and a portfolio of major brands, while demand has historically increased broadly in line with GDP. The company is also well positioned in growth markets, which it targets to account for 50% of sales over the medium term. Relative weaknesses, however, are some exposure to the general economic environment and to volatile and rising input costs.

The ratings are constrained by the company's intermediate financial risk profile. We view the company's historical credit metrics as only average, although they strengthened substantially following the disposal of the National Starch division and a drop in the pension deficit. On the other hand, we believe Akzo's generation of funds from operations (FFO) is recurring and free cash flow potential strong. The main financial risk remains in our view asset-liability risks relating to Akzo's sizable postretirement obligations, with gross pension obligations of €14.6 billion offset by €13.1 billion in pension assets at year-end 2010.

Key business and profitability developments

The current supportive chemical industry outlook should support management's target of growing sales and EBITDA by over 5% in 2011. Consequently, we expect reported EBITDA before incidentals to exceed €2 billion (€1.96 billion in 2010). We also believe the group's medium-term EBITDA target of 13%-15% as achievable (13.4% in 2010). However, Akzo's margins at its coatings segment--which averaged 12.2% in 2010--are likely to come under some pressure in the first half of 2011 due to the negative impact from strongly increased raw material prices, which we expect to be passed on to customers with a time lag. We expect the company's chemical segment to continue to post strong results in 2011, like in 2010 when EBITDA margins jumped to 19%.

Key cash flow and capital-structure developments

Akzo's credit metrics improved significantly in 2010, notably thanks to a strong reduction in adjusted debt to €3 billion from €4.5 billion. This was made possible thanks to €1.1 billion in disposal proceeds (notably from National Starch) and a drop in the group's pension deficit to €1.15 billion from €1.8 billion.

We expect the group's medium-term free cash flow, excluding the impact of ongoing large pension top-up payments, to be about €0.5 billion per annum. However, a major part of this is absorbed by the group's €0.4 billion dividend (including to minorities). In 2010 Akzo generated adjusted FFO of €1.2 billion, comfortably exceeding adjusted capital spending of €0.68 billion.

Under our credit scenario we expect Akzo's adjusted FFO-to-net debt metrics to remain close to 40%, compared with 41% in 2010, up from a modest 28% in 2009. We have, however, assumed that the company will use the bulk of its large cash balances (€2.9 billion reported) in a credit-friendly way--including partly for gross debt--and make no large acquisitions.

The current financial headroom also serves as a buffer in our view against the high sensitivity of Akzo's pension deficit to discount rates as observed in 2009. At the same time, we view positively management's actions to continue pension top-up payments of €0.4 billion in 2011, as well as the low (16%) allocation of equities in the €13.1 billion pension plan assets.

Liquidity

The 'A-2' short-term rating reflects our view of the company's "strong" liquidity profile with liquidity sources exceeding liquidity needs by over 1.5x in 2011.

Liquidity sources at year-end 2010 comprised:

- High reported cash of €2.9 billion. We treat €0.4 billion of this as tied to operations to take into account seasonality as well as restricted cash.
- €1.5 billion in credit facilities maturing in 2013 that are not subject to any financial covenants and were reported as undrawn.
- Positive free cash flow in the order of €0.5 billion but which will be largely consumed by the group's €0.4 billion pension top-up funding.

Liquidity uses for the next 12 months may include:

- Short-term debt of €0.9 billion in 2011 and minimal debt maturities in 2012.
- Capital expenditure levels of about €0.6 billion.
- Dividend payments (including to minorities) of about €0.4 billion.
- Likely working capital outflows in light of raw material price increases and volume growth.

Outlook

The stable outlook reflects the current supportive operating environment, and the financial headroom re-established since 2010. We consider a level of FFO to debt of above 30%--while the company remains free cash flow positive after dividends--to be consistent with the ratings.

Rating downside is currently unlikely in our view, given financial flexibility restored in Akzo's credit metrics. Downside could however result from unexpected material acquisitions or shareholder distributions.

Rating upside depends on sufficiently supportive financial policies, and management's commitment to recently improved credit metrics.

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