

Akzo Nobel N.V. (05/01/2017)

The fund bought a 4% position in Akzo Nobel N.V. from July to October 2016 at EUR 58.52.

Akzo Nobel N.V. (Akzo Nobel) is a Dutch based business with three core operating divisions; decorative paints, performance coatings and specialty chemicals. The origins of Akzo Nobel date back over 350 years. The Nobel prize is funded from the [estate](#) of Alfred Nobel, the founder of business interests that were ultimately acquired by Akzo Nobel from a Swedish state owned entity in 1994.

The enterprise value of the business is EUR 16.5B. It carries net debt of EUR 1.1B and generates around EUR 1.5B in EBIT from revenues of EUR 14B. (These headline numbers ignore the pension cash flows and economics; unfortunately.)

Akzo Nobel holds leading (#1 or #2) positions in decorative premium paints in various developed and emerging markets globally including UK, Ireland, Netherlands, Scandinavia, China, India, Indonesia, South Africa, Brazil and Argentina. Decorative paint businesses have long standing widely recognised brands. Akzo Nobel's brands include Dulux, Flexa, Sadolin, Nordsjo and Coral. The businesses tend to be highly cash generative, defensible and produce reasonably stable and growing real cash coupons over long periods. Their success is dependent on locally focused market execution; there is competition, the paint won't sell itself. The businesses need to be supported through marketing and some product development. Trade customers are also cultivated and supported with credit, training and loyalty incentives. Well run, established decorative paint businesses with strong market positions are highly desirable investments.

Akzo Nobel's performance coatings business holds leading global market positions in various lines including powder, marine, yacht, aerospace, coil, wood and protective coating markets. Coatings are branded, they carry genuine IP, they provide a solution to their users. Coatings are usually sold in bulk amounts directly to customers, who are often large global OEMs. There are meaningful barriers to entry to get onto approved product lists. Global end markets tend to be reasonably small from a revenue perspective (circa USD 300m – 2B) and dominated by two or three global players at the top end (Akzo being one of the three) and more fragmented local players in the various geographies. Akzo Nobel's performance coatings products are highly regarded globally. In 2015, the division generated revenues of EUR 6B, EBIT of EUR 790m and a pre-tax return on invested capital of nearly 30%. It is a highly desirable business.

Two-thirds of Akzo Nobel's business is reflected in the decorative paints and performance coatings divisions. Other large businesses with exposures to decorative paint and / or performance coatings activities include PPG Industries Inc (US:PPG), Valspar Corp (US:VAL), Sherwin William Corp (US:SHW) and locally listed Dulux (ASX:DLX). Each of these four businesses operationally performed

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reasonably well through the GFC and recovered strongly in the subsequent years. These businesses have been defensible and resilient. Their capital investment requirements have been modest through the cycle and they have delivered stable and growing real coupons for their owners. These attractive characteristics and strong operating performances have also been reflected in the share price appreciation of each of these four businesses over the past 10 years.

The steady progress and performance of these four other businesses is in contrast to Akzo Nobel's performance (in decorative paint particularly) over this period. This is more curious to us given arguably Akzo Nobel holds more attractive assets.

Akzo Nobel has been involved in numerous mergers, acquisitions and disposals over the years. The current business was meaningfully shaped by Akzo Nobel buying Imperial Chemical Industries Plc (ICI) in 2008. Akzo Nobel paid an EV of GBP 9.7B for ICI, a business that at the time was generating GBP 500m in EBIT. In addition, ICI came with large employee pension plans and obligations. Akzo Nobel's attraction to ICI was to:

- Expand its decorative paint business, ICI's key decorative brands included Dulux, Glidden, Coral, Cuprinol and Polyfilla; and
- Gain access to the emerging market exposures that ICI held. At the time of the acquisition, ICI "Decorative" positions in emerging markets were China #2, India #3, Indonesia #2, Malaysia #1, Pakistan #1, Thailand #2, Vietnam #2 and Argentina #1.

We regard the strategic intent around the acquisition as being reasonable. The trouble was they paid a very high price and in hindsight the timing has proved to be poor. The operating performance of Akzo Nobel has been disappointing since. This lacklustre operating performance has been further complicated by the large pension assets and obligations Akzo Nobel assumed as part of the ICI acquisition. The combination of mixed operating performance and high underlying financial risk has caused the company to be too difficult for most investors.

Since the ICI acquisition there has been a meaningful turnover of Members of the Board (5 of the current 8 members of the Supervisory Board joined after the ICI acquisition). In 2012, Mr Ton Buchner was also appointed CEO. His focus has been on realising a reasonable return from the existing asset base; with an objective of generating financial returns that reflect the apparent quality of these assets. This refocus has involved a number of steps including the sale of their North American Decorative paint business in 2012, and an extensive multi-year internal restructuring program articulated in 2012 which to date has involved significant cost reductions, systems rationalisations, standardisation of work practices, transparency and accountability for the financial returns across business areas, and focus on supply chain rationalisation and efficiencies. There has been some confirmation of gains from these initiatives in the recent financial results of the business.

We regard this internal refocussing as an ongoing multi - year process and genuine longer term opportunity. Akzo Nobel's decorative paint business holds strong, well established brands and market positions in highly desirable developed and emerging markets. The restructuring to date has been about flattening out the cost base and aligning the business practices. It is an incredibly broad geographically exposed portfolio, where the success in each market is dependent on locally nuanced, in market, on the ground execution. There needs to be consistent brand reinvestment, product development, meaningful engagement with both their retail and trade customers and adequate supply chain and distribution to support the operations. The prize is huge though. If they

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can get this execution right, they should deliver consistent volume growth through the cycle, real price increases in addition to volume and a positive mix shift as the market increasingly trades up to premium paints. There is clear confirmation of operating improvements in Akzo Nobel's recent results; we view this progress as encouraging. At the current valuation, we don't think we are paying anything for the longer term investment opportunity that we perceive.

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