

Analyst Corner

By: Nathan Ritz, CFA · April 2018



An Introduction to Axalta Coating Systems (AXTA)

Axalta is a global leader in coatings (paint) for automotive and industrial end markets. They serve light vehicle and commercial vehicle OEMs (original equipment manufacturers) and auto body shops through their automotive refinish segment. Over the past five years, management has pushed to expand their industrial coatings business both through internal investment and bolt-on mergers and acquisitions (M&A). Their industrial coatings segment consists of pipe coatings; powder and coil coatings for appliances, machinery, and architectural end markets; electrical insulation coatings; and most recently wood coatings via their acquisition of Valspar's North American wood coatings business.

New Management Behind the Wheel

While a young public company (IPO in 2014), Axalta is over a century old, founded in 1866 as a division of DuPont. Under the DuPont umbrella, the automotive coatings business was deemed "non-core" and was harvested for the strong free cash flow the business threw off. This led to underinvestment in the business and in geographies where there was a longer runway to realizing returns. Additionally, DuPont pushed pricing too hard at OEMs, which led to bad blood and lost contracts. Carlyle Group took the business private in 2013 and brought in new management. In all, 80 of the top 120 executives were replaced.

New CEO Charlie Shaver and his team have taken meaningful steps to improve the business. They have reduced waste and streamlined operations, taking \$200 million of costs out since 2014. Management realigned their sales process around the end customer, rationalized their SKU count and focused their R&D on customer value gaps. Capital allocation has improved, as dollars have been directed to the highest impact, risk-adjusted ROI (return on investment) projects. They also took actions to repair customer relationships and invested in growth, including a new foray into Asia. Management identified roughly \$2 billion of profit pools that were neglected under DuPont, and we have seen market share gains as their investments have begun to bear fruit. While management has made significant headway, we think there is additional runway ahead. At their investor day last month, management targeted \$200 million of additional cost savings over the next four years and approximately \$100 million of working capital improvements. This should help drive return on invested capital into the mid-teens over our investment horizon.

A Colorful Moat

Axalta is a critical link in their customers' production process. They add value to their customers by offering superior coatings chemistry and the largest color library in the industry. Equally, if not more important, they improve their customers' operations through the application process, where costs are 3-4x the cost of the coating itself. Their core automotive OEM and refinish customers care about quality and increasing the number of cars they can get through the paint booth, as defects/reworks are expensive. For OEMs, Axalta developed "harmonized coatings technologies," which combines coatings stages (e.g., combined primer and basecoat, basecoat and clearcoat, or wet on wet applications, which removes a curing stage). These application processes increase throughput and take capital, energy and labor costs out of operations. In refinish, we have seen widespread adoption of waterborne coatings, which are more complex to apply but increase the throughput of the paint booth. It is common to see a body shop's gross profit increase 20-30% once Axalta is brought in. Axalta has technicians in the body shops and on the OEM floor who analyze and improve customer productivity. This intimate partnership with the OEM plant or body shop creates a sticky relationship and gives Axalta pricing power, particularly with refinish customers.

There are several industry trends that have benefited global coatings leaders that we expect to continue going forward. Technology, both in coatings and in application, has become increasingly important, as complexity has increased, and the industry is shifting toward more environmentally friendly coatings. Axalta and PPG are global leaders in waterborne coatings (water replaces oil-derived solvents as the liquefying agent), which have been taking share in Europe, North America and Asia. Importantly, the shift is being driven not only by environmental regulations but also economics given the higher productivity of waterborne coatings. Additionally, we have seen application complexity increase at OEMs as they have grown customization and design complexity (two-tone paint) and have shifted toward mixed substances (aluminum, carbon fiber, plastics, metal alloys). This makes application efficiency and innovation increasingly important. Scale in R&D is important, as is service density. Waterborne has a more complex application process and more stringent climate control requirements in the paint booth. This makes Axalta's dense network of training and service centers increasingly valuable.

Finally, another positive secular trend is the growing sophistication among Axalta's customer base. We have seen consolidation among body shops, driven by economics and indirectly by insurance carriers, which has resulted in outsized growth for multi-shop operators (MSOs). For MSOs, productivity becomes the primary decision driver, favoring Axalta and PPG, a duopoly in the U.S. with close to 85% market share. As these secular trends continue to play out on a global scale, we expect the large entrenched incumbents, Axalta and PPG, to continue to benefit disproportionately compared to smaller peers.

Temporary Roadblocks

We were able to build positions in Axalta beginning in fall of 2017 as the stock dipped on fears around raw material inflation hitting margins, weak OEM pricing and refinish volume concerns due to several of their largest customers de-stocking inventory after a round of acquisitions. We expected these were short-term issues that could be worked through over the next 3-4 quarters. In fact, the inventory adjustment appears to be over, as Axalta reported volume improvement in refinish in Q4 and strong guidance for 2018.

Periods of high raw material inflation lead to margin compression for coatings players. Axalta's propylene-derived resins and solvents are seeing mid-single to high-single-digit inflation, and some pigments like TiO₂ are seeing double-digit inflation. This has led to margin compression that is likely to continue in Q1 and Q2. However, the coatings group has historically exhibited strong pricing power, especially compared to chemical peers, and has been able to pass through raw material inflation. Axalta has price escalators baked into contracts, and certain categories like automotive refinish have been able to pass through pricing with little lag. It takes longer to pass through pricing at auto OEMs given contract renegotiation periods; however, price increases were announced in March (some have taken effect already), and we expect others will flow through as the year progresses. We project margins will inflect for Axalta in the second half of the year as price increases and cost savings take hold.

Multiple Roads

We believe there are multiple avenues Axalta's management can take to create shareholder value. The first is through continued organic investment and M&A. We think there is a large opportunity set for potential acquisitions where Axalta can leverage their technology, distribution network, procurement scale and operating system to create value and drive strong returns on invested capital. There are 25 coatings companies with revenue over \$400 million and over 90 with revenue greater than \$100 million. We expect industry consolidation to continue and for Axalta to be a key beneficiary.

The second lever would be an outright sale of the company. In October of last year, Akzo Nobel, the third-largest global coatings company, made an offer for Axalta. Management rejected the offer in November and announced that they were in talks with Asian coatings leader Nippon Paint. Later that month, management announced they ended talks, deeming Nippon's \$37 per share offer as inadequate. There are likely additional industry players interested in Axalta's assets, and we expect there is a fair probability that Akzo Nobel returns to the table. While a takeout is not our core thesis, we think there is upside from a possible deal in the low \$40s per share. Regardless, we expect to earn a low-teens return on our investment on a stand-alone basis.

***Nathan Ritz, CFA**, Research Analyst, joined Weitz in 2011. He graduated from the University of Nebraska-Lincoln and became a CFA® charterholder in 2015. He previously completed an internship with Moody Aldrich Partners in Boston and worked as an analyst for West Gate Bank.*

As of March 31, 2018, Axalta Coating Systems Ltd. constituted a portion of the net assets of Partners Value Fund, Hickory Fund, and Balanced Fund as follows: 2.1%, 2.7%, and 1.4%. Current and future portfolio holdings are subject to risk.

Investors should consider carefully the investment objectives, risks, and charges and expenses of the Funds before investing. The Funds' Prospectus contains this and other information about the Funds and should be read carefully before investing. The Prospectus is available from Weitz Investment Management, Inc. Weitz Securities, Inc. is the distributor of the Weitz Funds.