

CREDIT OPINION

30 October 2019

Update



RATINGS

SGS SA

Domicile	Switzerland
Long Term Rating	A3
Type	LT Issuer Rating - Dom Curr
Outlook	Stable

Please see the [ratings section](#) at the end of this report for more information. The ratings and outlook shown reflect information as of the publication date.

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SGS SA

Update to Credit Opinion Following Affirmation of A3 Corporate Family Rating

Summary

SGS SA (SGS or the company) is the market leader in the global testing, inspection and certification (TIC) industry. [The sector has solid growth fundamentals](#) driven by a range of factors, such as economic and population growth in emerging markets, increasing complexity of supply chains, the importance of brand reputation and regulation.

SGS has a relatively high level of sector and geographic diversity which helps to support stability of earnings, delivering positive annual organic revenue growth throughout the economic cycle. However it also has substantial exposures to cyclical sectors, notably within the oil, gas and chemicals division (representing approximately 18% of revenues in the last 12 months ended 30 June 2019) and the minerals division (11%). Although the global economic outlook is softening, we continue to expect revenue growth in the low to mid-single digits over the next 12-18 months driven by strong sector fundamentals.

New developments in automation, robotics and artificial intelligence, among others, are disrupting the global economy and the testing, inspection & certification (TIC) industry is no exception. Some of the more labour-intensive and simple tasks, such as physical inspections have been automated using digital inspections or drones, reducing operating costs and increasing efficiency but also increasing the risk of added competition and disintermediation. The increasing use of digital technologies opens an opportunity for TIC companies that are able to harness and process data from different sources, enabling them to provide value-added services to customers around data management and analytics. Leading players such as SGS are well placed to adapt and take advantage of these opportunities. We expect substantial business transformation and additional investment as SGS develops its ongoing technology strategy.

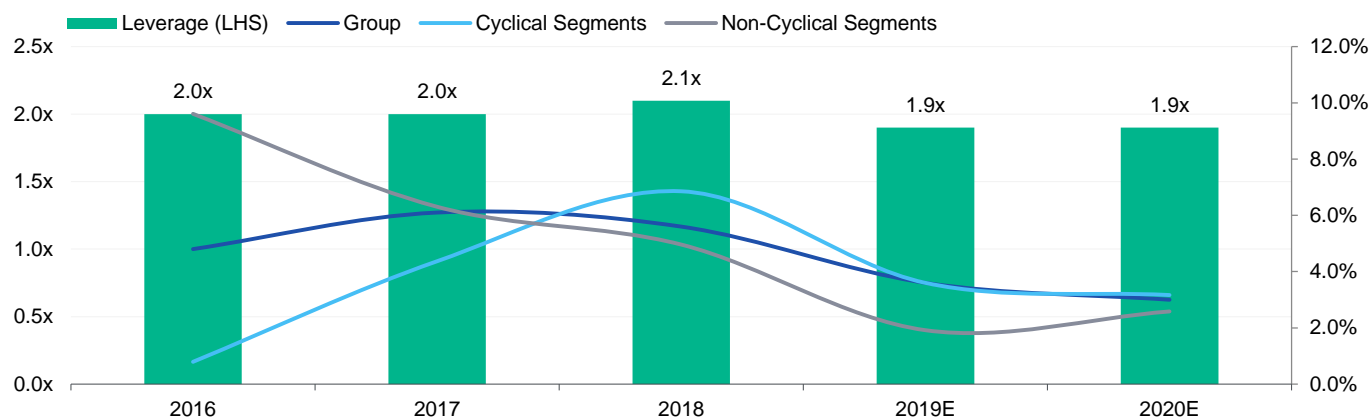
The company achieves high adjusted operating margins (15.7% in 2018, reported basis), and the company targets further margin growth of 1.3 percentage points through to 2020. Organic growth, and initiatives in procurement, productivity and digitalisation are expected to support this. However we envisage some challenges to reach this target coming from the softening economic outlook, price pressure in certain commoditised testing, investments in the business model and technology.

The company delivers high levels of operating cash flows and has conservative balance sheet and financial policies. At 30 June 2019, Moody's adjusted net leverage was 1.4x and Moody's-adjusted gross leverage was 2x. We expect this to remain in the 2x range, with acquisitions and shareholder distributions likely to be financed largely from existing cash generation.

Exhibit 1

Solid revenue growth fundamentals expected to sustain organic growth

% change in organic revenues (LHS) and Moody's-adjusted leverage (RHS), 2016-2020 (f)



Revenue growth of cyclical segments represented by Oil, Gas & Chemicals, Minerals and Industrials Divisions; non-cyclical segments represented by all other divisions

Source: Company reports, Moody's estimates

Credit Strengths

- » Strong long-term track record of growth through the cycle and positive long-term industry growth dynamics
- » Market leadership, global reach and sector diversity
- » Cost saving opportunities offsetting price pressure in mature segments and costs of internal systems and business development
- » Low leverage, high operational cash generation and solid liquidity

Credit Challenges

- » Exposure to oil and gas and minerals sectors with fluctuations in capital investment cycles and commodity prices
- » Increasing digitalisation and technological changes within the market
- » Currency translation exposures particularly to depreciating emerging markets currencies

Rating Outlook

The stable outlook reflects primarily the solid positioning in the A3 category and our expectation that the company will generate continued positive organic growth, that the long-term growth outlook of the industry is sustained and that the company maintains conservative financial policies with low leverage and solid liquidity.

Factors that Could Lead to an Upgrade

Positive pressure on the ratings could arise if (1) Moody's-adjusted leverage falls comfortably below 2x on a sustainable basis; (2) Moody's-adjusted retained cash flow/net debt in the mid-30s in percentage terms or above while maintaining positive organic growth and stable or growing margins; and (3) the company maintains a conservative financial policy.

Factors that Could Lead to a Downgrade

Negative ratings pressure could develop if (1) Moody's-adjusted leverage increases above 2.5x on a sustainable basis; (2) there is a material decline in growth or profitability for a sustained period of time; (3) Moody's-adjusted retained cash flow/net debt falls below the mid-20s in percentage terms or (3) the company adopts more aggressive financial policies in relation to leverage, shareholder distributions and/or liquidity.

This publication does not announce a credit rating action. For any credit ratings referenced in this publication, please see the ratings tab on the issuer/entity page on www.moody's.com for the most updated credit rating action information and rating history.

Key Indicators

	12/31/2014	12/31/2015	12/31/2016	12/31/2017	12/31/2018	12/31/2019F	12/31/2020F	12/31/2021F
Revenue (USD billion)	\$6.4	\$5.9	\$5.9	\$6.6	\$7.0	\$7.2	\$7.4	\$7.6
EBITA Margin	16.8%	16.9%	15.5%	15.7%	15.8%	16.2%	16.0%	16.0%
Debt/ EBITDA	1.7x	2.1x	1.7x	2.0x	2.1x	1.9x	1.9x	1.8x
EBITA / Interest	16.3x	15.3x	16.7x	16.9x	15.5x	14.7x	14.9x	15.3x
RCF / Net Debt	60.7%	27.8%	37.6%	41.3%	35.6%	34.1%	32.4%	32.1%

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations.

[2] This represents Moody's forward view, not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures

Source: Moody's Financial Metrics™

Company Profile

SGS is the global leader in the testing, inspection and certification market. The company is headquartered in Geneva, Switzerland and is listed on the Swiss Stock Exchange. The company's market capitalisation was CHF16.8 billion as at 23 October 2019.

SGS operates a network of approximately 2,600 offices and laboratories worldwide and employs over 97,000 staff. In the six months ended 30 June 2019, the company reported revenues of CHF3.3 billion and adjusted operating income of CHF489 million.

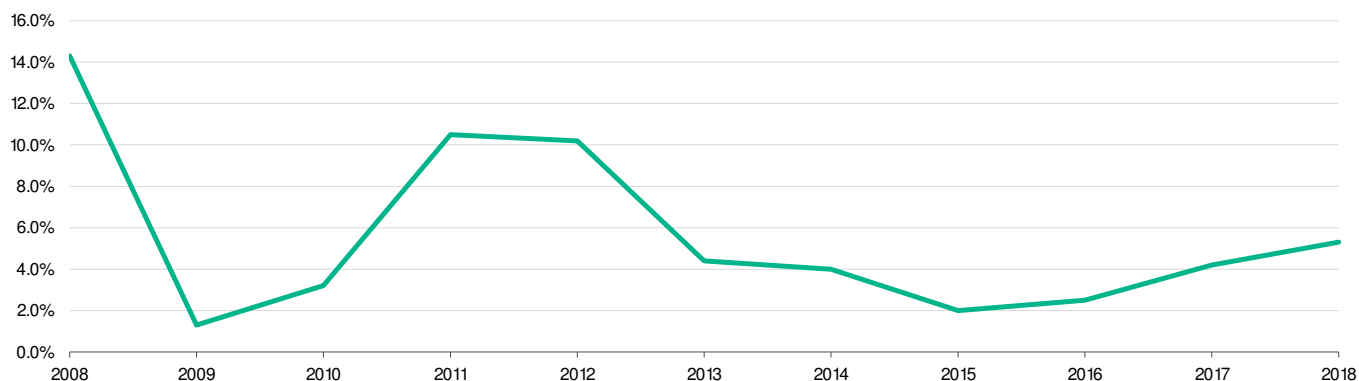
Detailed Credit Considerations

Long-term track record of positive organic growth and positive long-term growth fundamentals

SGS has delivered positive organic revenue growth through the cycle, with a low of 1.3% in 2009 and positive growth in each of the last 10 years. This reflects the company's high sector, geographic and customer diversity and its entrenched positions with customers. Customer retention rates are very high supported by the company's strong reputation, the low relative cost of its services and integration of upstream laboratory activities into customer operations.

Exhibit 3

Organic revenue growth has remained positive over the last 10 years



Source: Company

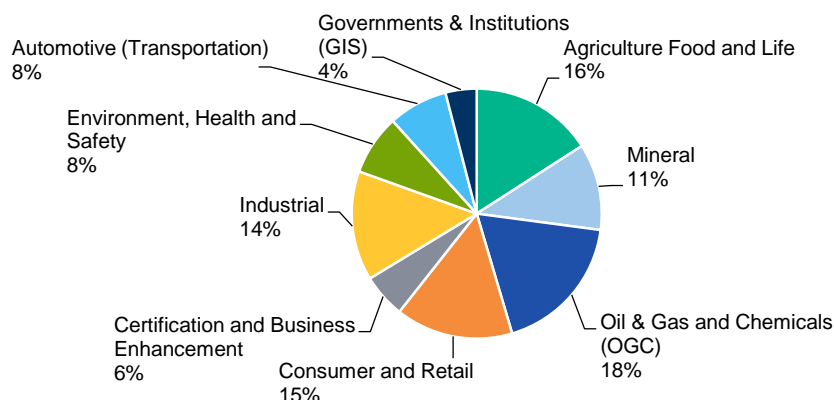
Despite a significant exposure to cyclical sectors, as detailed further below, SGS benefits from high levels of sector diversity and strong levels of growth within the TIC sector as a whole. This is driven by a range of factors, in particular increasing regulation and regulatory demand for independent testing, increasing customer focus on regulatory compliance and risk management, greater demand for product quality amongst emerging markets consumers, the growing complexity and globalisation of supply chains, and growing concerns over environmental, health and safety and food standards. These factors have historically driven growth (excluding cyclical factors) in the mid to high single digits. Positive changes in regulatory regimes globally could partially be offset by the impact of global trade tensions, that have the potential to reshape trade flows and global supply chains.

High levels of sector and geographic diversity

SGS is organised as nine divisions operating across a diverse range of sectors and geographies. Revenues are well spread across divisions with no division accounting for more than 18% of group revenue. The largest customers include oil majors, national governments, retailers and energy companies, whilst customer concentration is low. The diversity of revenues has enabled the company to achieve long-term positive organic growth at a group level over periods of constraints in capital investment and in commodities-related markets.

Exhibit 4

Revenues are well spread across divisions
Split of total revenue by division, LTM H1 2019



Source: Company

Revenues are spread across Europe, Middle East and Africa (EMEA, 43% of 2018 revenues), Asia Pacific (30.7%) and Americas (26%). Emerging markets in total represent approximately 50% of revenues and are a key driver of growth due to increasing trade flows, improving product quality standards and growth in private consumption.

Leading market position in a highly fragmented industry with significant M&A activity

A large share of TIC activities are still conducted in-house or by public organisations, but we expect that outsourcing will continue given the increased volumes and complexity created by the trends above. In the outsourced market (about 40% of total) the top 20 companies globally have around a 40% combined market share, followed by a long tail of smaller companies. According to Barclays, the three largest companies (SGS, Bureau Veritas and Intertek) account for less than 25% of the total outsourced market.

SGS is the global leader in the TIC market, with the highest levels of growth and sector diversity amongst the top three global players. The company also competes with a number of more sector-focused operators such as Eurofins (food and biopharma), ALS Global (minerals and life sciences), Core Labs (oil and gas) and Applus (automotive and industrial).

As a result of the fragmentation, there is significant M&A activity in the market, largely bolt-on acquisitions that contribute additional footprint, technical capabilities or products to the acquirer's portfolio and can be a more efficient use of capital than the large investments required to compete effectively with the acquiree. The company continues to accelerate its M&A activity as part of its 2020 strategic plan, with seven acquisitions and strategic partnerships completed in the last six months ended 30 June 2019. SGS has a target of acquiring revenue of CHF1 billion over 2016 to 2020, of which approximately CHF315 million has been added through to 30 June 2019.

Increasing digitalisation and technological changes within the market

The TIC sector is well-suited to technological innovation and is expected to see considerable change both in the way services are delivered and in the digitalisation of its customer base. Innovations in robotics, automation, the use of sensors, data analytics, artificial intelligence, crowdsourcing and blockchain are expected to change the industry over the next five years. In addition the growth of e-commerce is changing the nature of TIC requirements with sourcing, fraud detection and assurance and cyber-security key service

elements. The attractiveness of this market is evident by the high adjusted operating income margins achieved by SGS's consumer and retail division, at 26% in fiscal 2018, well ahead of group total (15.7% in fiscal 2018).

These changes are expected to bring opportunities but also the threat of disruption. Some of the more labour-intensive and simple tasks, such as physical inspections have been automated using digital inspections or drones, reducing operating costs and increasing efficiency but also increasing the risk of added competition and disintermediation as customers could potentially take these TIC functions back in house.

However we view the larger TIC companies such as SGS as well placed to respond to these challenges, with their scale, strength of reputation, global networks and long-term customer relationships enabling companies to invest in and commercialise new technologies.

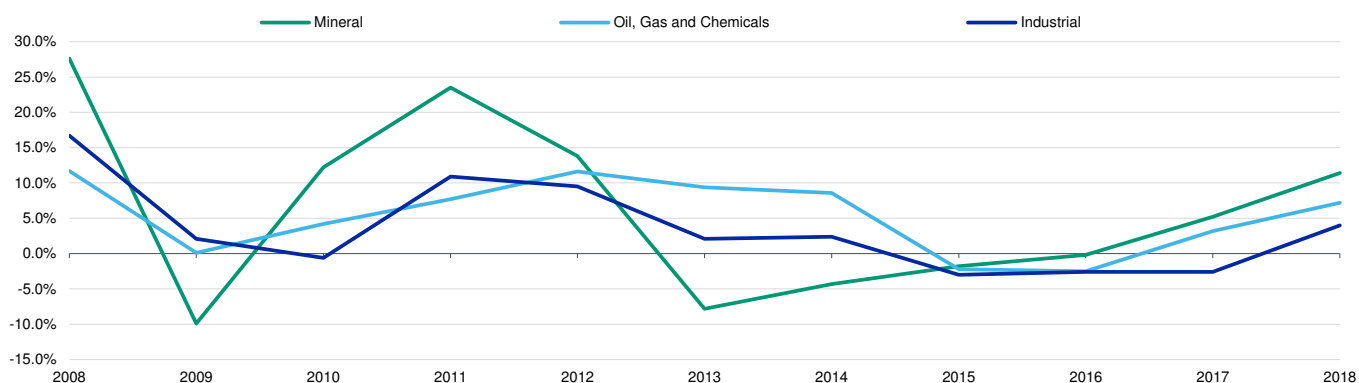
SGS is adapting its offering in response to these changes with an investment programme to improve its technology platform and develop its business model as well as through selective technology-driven acquisitions. We expect that the costs of this transformation, and the softening global economic outlook, may make the company's margin ambitions challenging, as seen on their recent announcement of a reviewed adjusted operating income margin target for 2020 above 17%.

Exposure to cyclical oil and gas and minerals markets

Whilst there is a broad sector diversity SGS is exposed to certain commodity markets, in particular the oil & gas ("OGC") and minerals sectors. The OGC division represented approximately 18% of group revenues in the last 12 months to June 2019, with significant additional exposure to the sector within the industrial division, which represented 14% of company revenues. SGS's exposure is spread across the entire value chain from exploration and production, distribution, refining and retail. Approximately 2% of group revenues are derived from upstream exploration and production activities which are most exposed to variations in the oil price. The minerals sector represented approximately 11% of company revenues in the last 12 months to June 2019, and has shown significant volatility historically, as it has gradually moved upstream from trade inspection to geochemistry services for exploration.

Exhibit 5

Organic revenue growth for cyclical sub-sectors over the last 10 years



Source: Company

The OGC, minerals and industrial divisions continued a steady performance in June 2019, with organic revenue rates (in constant currency) ranging from 3-7%. The growing momentum in the upstream oil & gas segment has benefited both the OGC and the industrial division, whereas the minerals division is sustained by increased volumes of testing globally,

In total the OGC, minerals and industrials divisions represented 43.6% of revenues in the last 12 months to June 2019, a steady proportion of the total group as the company continues to diversify and shift towards other sectors. The company continued to record solid results, with approximately 3.5% organic revenue growth in the six months to June 2019, with growth rates impacted by the transportation and government & institutions divisions, that were affected by reduced price pressure in the regulated services and lengthy implementation of recently signed contracts respectively.

Exposure to emerging market currencies and risks of ongoing currency depreciation against the swiss franc

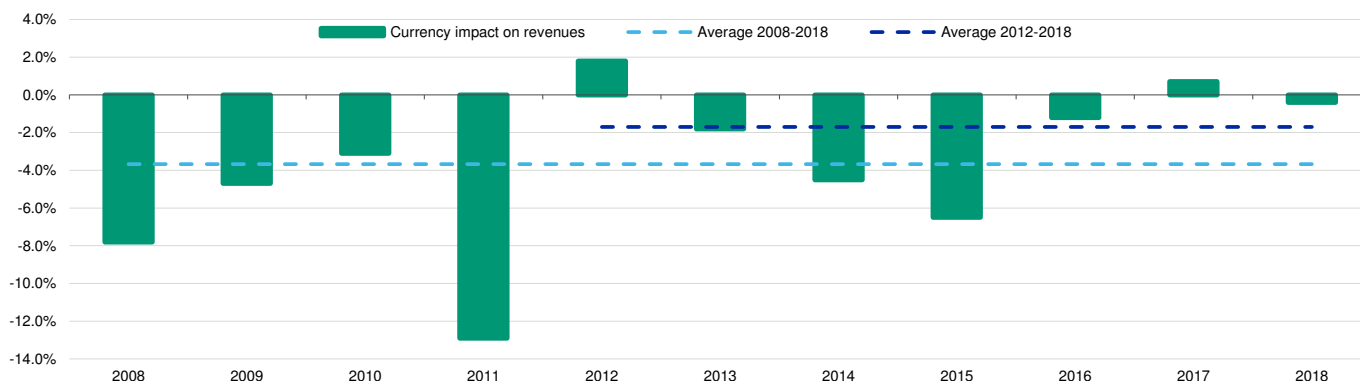
Currency movements have had a significant impact on historic trading results, as the company has very limited trading activity in CHF (representing less than 2% of revenue). Adverse currency movements have been experienced in each year since 2009 except for 2012 and 2017.

The largest currency exposures are to the euro (26.4% of H1 2019 revenues), US dollar (14.7%), and the Chinese renminbi (14.3%), and around half of revenues are in emerging markets currencies. The high emerging markets exposure is likely to give rise to long-term currency depreciation given the higher inflation rates in these economies. The company seeks to mitigate these risks through both inflation and currency indexation in a proportion of its contracts.

Exhibit 6

Currency effects have reduced revenues by just under 2% on average since 2012

Annual revenue impact of currency movements 2008-2018



Source: Company presentations, Moody's analysis

In the six months ended 30 June 2019, SGS was impacted by currency depreciations against the Swiss Franc, resulting in a 2.8% revenue decrease.

As a result of exposure to depreciating emerging markets currencies we expect that SGS will continue to experience currency depreciation reducing revenue growth by an average rate of around 1-2% per annum, although with significant annual variations.

Low leverage and high operational cash generation

Leverage is low with Moody's-adjusted gross leverage of 2x at 30 June 2019 after adjusting for pensions and operating leases. The company retains significant levels of cash and marketable securities of approximately CHF874 million at 30 June 2019 and net leverage is 1.4x on a Moody's-adjusted basis. Cash generation is strong with low debt servicing costs and leading to reported operating cash (before capex) conversion of between 78% and 85% of EBITDA over 2015-2018.

Exhibit 7

LTM June 2019 Moody's adjusted leverage reconciliation

CHF million	LTM June 2019	CHF million	LTM June 2019
Pretax income	1,120	Reported Debt	2,964
Interest Expense	50		
Depreciation	400	Moody's pensions adjustment	119
Amortisation	33	Moody's operating leases adjustment	(89)
Moody's pensions adjustment	1	Moody's Adjusted Debt	2,994
Moody's operating leases adjustment	119		
Company other non-recurring items	(201)		
Moody's Adjusted EBITDA	1,522	Moody's Adjusted Leverage	2.0x

Source: Moody's Investors Service

SGS' M&A strategy is well defined and the annual expenditure is relatively low in the context of cash generation and its is partially offset by the ongoing portfolio optimisation, which includes the disposal of already identified underperforming and non-core business with a combined revenue of CHF350 million (the majority has been completed).

Dividend distributions and the company's share buyback programmes tend to be financed from internally generated cash with limited requirements for additional debt funding.

Whilst the company has not stated a leverage target, we expect it to maintain a conservative financial structure with leverage in the 2x range on a Moody's-adjusted basis.

Environmental, Social and Governance considerations

Whereas we consider that SGS exposure to environmental and social risks is low, the structural trends that underpin the expected growth in the TIC industry are heavily linked to environmental and social considerations, given the increased focus on product quality, safety standards and sustainability from consumers, and the expanding regulation on environmental and product safety considerations.

With regards to corporate governance, the changes in the executive management team, including the CFO, have not resulted in a change in strategy or financial policy, which remains conservative.

The company's reputation as a trusted provider is critical to its success and any decline its standing, through poor quality of testing or weakness in its control environment could have a material effect. The company has a strong control culture to protect its reputation. It operates staff rotation, has a matrix reporting structure with local country managers and divisional heads, and carries out internal audit procedures, as seen in Brazil during 2018, as well as random inspections and issuing anonymous samples to test quality and accuracy of results. Quality issues continue to be relatively limited and isolated in nature.

Liquidity Analysis

The company has a solid liquidity position with balance sheet cash and marketable securities of approximately CHF874 million at 30 June 2019. It also has CHF600 million committed facilities available until 2021 which were undrawn as at 30 June 2019.

Rating Methodology and Scorecard Factors

The principal methodology used in rating SGS was the Business and Consumer Service Industry Rating Methodology published in October 2016. Please see the Credit Policy page on www.moody's.com for a copy of this methodology.

Exhibit 8

Business and Consumer Service Industry Scorecard [1][2]			Current LTM 06/30/2019		Moody's 12-18 Month Forward View As of 10/24/2019 [3]	
Factor 1 : Scale (20%)	Measure	Score	Measure	Score	Measure	Score
a) Revenue (USD Billion)	\$7.0	Baa	\$7.4	Baa		
Factor 2 : Business Profile (20%)						
a) Demand Characteristics	A	A	A	A		
b) Competitive Profile	A	A	A	A		
Factor 3 : Profitability (10%)						
a) EBITA Margin	15.3%	Ba	16%	Ba		
Factor 4 : Leverage and Coverage (40%)						
a) Debt / EBITDA	2.0x	A	1.9x	A		
b) EBITA / Interest	12.8x	A	14.3x	A		
c) RCF / Net Debt	23.4%	Ba	32.4%	Baa		
Factor 5 : Financial Policy (10%)						
a) Financial Policy	A	A	A	A		
Rating:						
a) Indicated Outcome from Scorecard		Baa1		Baa1		
b) Actual Rating Assigned				A3		

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. [2] Based on unaudited accounts as of 06/30/2019. [3] This represents Moody's forward view; not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures.

Source: Moody's Financial Metrics™

APPENDIX

Exhibit 9

SGS SA Summary Financial Metrics and Projections

In CHF million	2016	2017	2018	2019 proj [1]	2020 proj [1]
INCOME STATEMENT					
Revenue	5,985	6,349	6,741	6,945	7,153
EBITDA	1,357	1,433	1,522	1,604	1,632
EBIT	889	942	1,028	1,093	1,112
Interest Expense	61	56	68	77	77
BALANCE SHEET					
Cash & Cash Equivalents	975	1,383	1,752	1,306	1,157
Total Debt	2,423	2,840	3,233	3,063	3,063
CASH FLOW					
Capital Expenditures	452	480	460	482	482
Retained Cash Flow (RCF)	536	602	528	599	617
RCF / Debt	22.1%	21.2%	16.3%	19.6%	20.1%
Free Cash Flow (FCF)	131	86	127	77	107
FCF / Debt	5.4%	3.0%	3.9%	2.5%	3.5%
PROFITABILITY					
% Change in Sales (YoY)	4.8%	6.1%	6.2%	3.0%	3.0%
EBIT Margin %	14.8%	14.8%	15.2%	15.7%	15.5%
EBITDA Margin %	22.7%	22.6%	22.6%	23.1%	22.8%
INTEREST COVERAGE					
EBIT / Interest Expense	14.6x	16.9x	15.1x	14.2x	14.4x
EBITDA / Interest Expense	22.3x	25.8x	22.4x	20.8x	21.2x
(EBITDA - Capex) / Interest Expense	14.8x	17.1x	15.6x	14.6x	14.9x
LEVERAGE					
Debt / EBITDA	1.8x	2.0x	2.1x	1.9x	1.9x
Debt / (EBITDA - Capex)	2.7x	3.0x	3.0x	2.7x	2.7x
Net Debt / EBITDA	1.1x	1.0x	1.0x	1.1x	1.2x

[1] - This represents Moody's forward view, not the view of the issuer; and unless noted in the text, does not incorporate significant acquisitions and divestitures

Source: Moody's Financial Metrics™, Moody's projections

Ratings

Exhibit 10

Category	Moody's Rating
SGS SA	
Outlook	Stable
Issuer Rating - Dom Curr	A3

Source: Moody's Investors Service

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