Moody's
INVESTORS SERVICE

CREDIT OPINION
25 January 2018

Update

Rate this Research

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 2017 Results

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, in particular the increase in private consumption and demand for higher product quality in emerging markets, together with increasing regulation and focus on matters of health, safety, food and environmental standards globally.

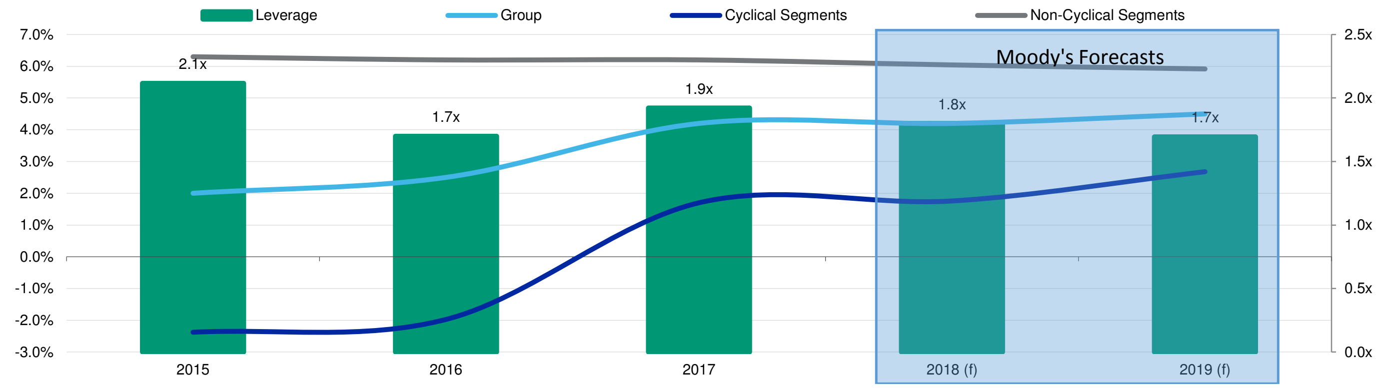
SGS has a relatively high level of sector and geographic diversity which helps to support stability of earnings, delivering positive annual organic revenue growth throughout the economic cycle. However it also has substantial exposures to cyclical sectors, notably within the oil, gas and chemicals division (representing approximately 18% of revenues in 2017) and the minerals and mining division (11% of 2017 revenues). Pressure on these sectors has contained growth since 2013 however recoveries commenced in 2017 and with a positive economic outlook for the majority of SGS's markets and positive sector fundamentals this should stimulate growth in the mid-single digits over the next 12-18 months.

The TIC industry is poised for significant technological change as developments in robotics and sensors, digitalisation, artificial intelligence, crowdsourcing and blockchain are set to transform TIC services and how they are delivered. This has the potential to disrupt the market in the medium term however leading players such as SGS are well placed to adapt and take advantage of the opportunities it will present. We expect substantial business transformation and additional investment as SGS develops its ongoing technology strategy.

The company achieves high adjusted operating margins (15.3% in 2017, reported basis), and the company targets further margin growth of 2.7 percentage points through to 2020. Cyclical upturn, and initiatives in procurement, productivity and digitalisation are expected to support this. However we envisage some challenges to reach this target coming from price pressure in certain commoditised testing, investments in the business model and technology and the potential need to share some margins with both customers and technology providers.

The company delivers high levels of operating cash flows and has conservative balance sheet and financial policies. At 31 December 2017 reported net leverage was 0.6x. Moody's-adjusted gross leverage was 1.9x and we expect this to remain in the range 1.7x-1.9x, with acquisitions and shareholder distributions likely to be financed largely from existing cash generation.

Exhibit 1
Organic revenues are expected to benefit from a sustained recovery in cyclical segments
% change in organic revenues (LHS) and Moody's-adjusted leverage (RHS), 2015-2019 (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) EBITDA margins remain stable; 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 EBITDA margins; or (3) the company adopts more aggressive financial policies in relation to leverage, shareholder distributions and/or liquidity.

Key Indicators

Exhibit 2

	12/31/2012	12/31/2013	12/31/2014	12/31/2015	31/12/2016	[2]31/12/2017	[3] 31/12/2018F	[3] 31/12/2019F
Revenue (USD Billion)	$5.9	$6.3	$6.4	$5.9	$5.9	$6.6	$7.0	$7.4
EBITA Margin	17.6%	17.5%	16.8%	16.9%	15.5%	15.5%	15.8%	15.9%
Debt / EBITDA	1.5x	1.3x	1.7x	2.1x	1.7x	1.9x	1.8x	1.7x
EBITA / Interest	16.1x	16.8x	16.3x	15.3x	16.7x	15.8x	17.0x	18.2x
RCF / Net Debt	53.0%	69.0%	60.7%	27.8%	37.6%	43.4%	40.8%	38.9%

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations.
[2] Preliminary data, based on 2017 unaudited accounts.
[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™

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 CHF19.4 billion as at 23 January 2018.

SGS operates a network of approximately 2,400 offices and laboratories worldwide and employs over 95,000 staff. In 2017 the company reported revenues of CHF6.3 billion and adjusted operating income of CHF969 million.

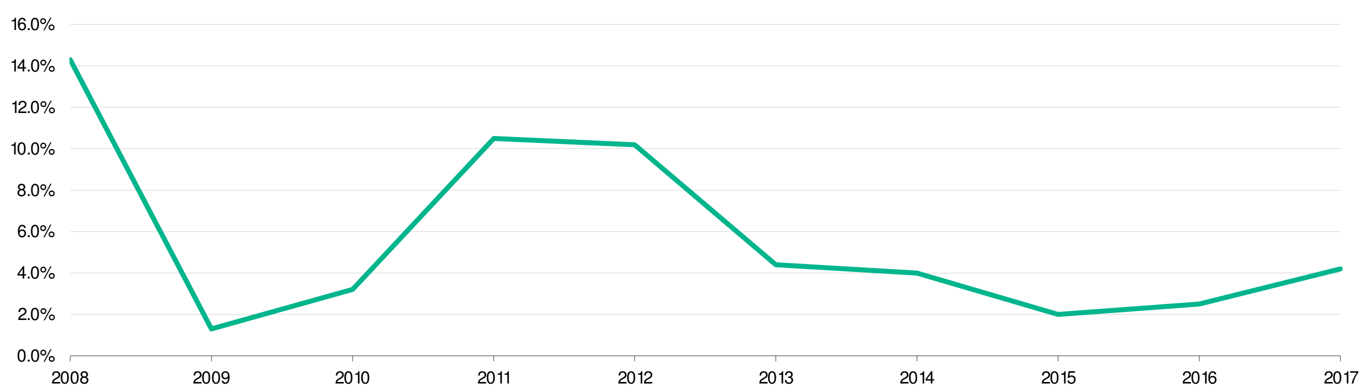
Detailed Credit Considerations

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, in particular in vehicle emissions testing in Europe and in environment and health and safety in the US are likely to provide continued positive growth momentum.

High levels of sector and geographic diversity

SGS is organised as nine divisions operating across a diverse range of sectors and geographies. Revenues are spread across Europe, Middle East and Africa (EMEA, 44.4% of 2016 revenues), Asia Pacific (30.0%) and Americas (25.6%). 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.

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.

Leading market position and higher growth rates and diversification than the leading competitors

SGS is the global leader in the TIC market, with the highest levels of growth and sector diversity amongst the top three global players. Bureau Veritas and Intertek are the #2 and #3 players respectively and closest competitors in terms of sector coverage, and SGS has the lowest exposure to upstream oil and gas segments amongst the top three companies. The company also competes with a number of more sector-focused operators such as Eurofins (food and biopharma), ALS Group (minerals and life sciences), Core Labs (oil and gas) and Applus (automotive and industrial). Beyond the major players the market is highly fragmented with over 25,000 commercial laboratories as well as in-house and government-run operations.

SGS is the leading player in the majority of its divisions including Oil, Gas and Chemicals Services (OGC) (the company estimated approximately 30% global market share in 2014), minerals (45%), consumer testing (10%), agricultural (60%), automotive (20%) and systems and services certification (10%), and with a circa 5% share in the fragmented industrial segment.

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.

These changes are expected to bring opportunities but also the threat of disruption. Virtual TIC brokers or a crowdsourcing model may provide field inspections at lower costs than the networks of existing providers. The larger e-commerce providers such as Amazon and Alibaba may seek to self-certify and limit the demand for independent testing.

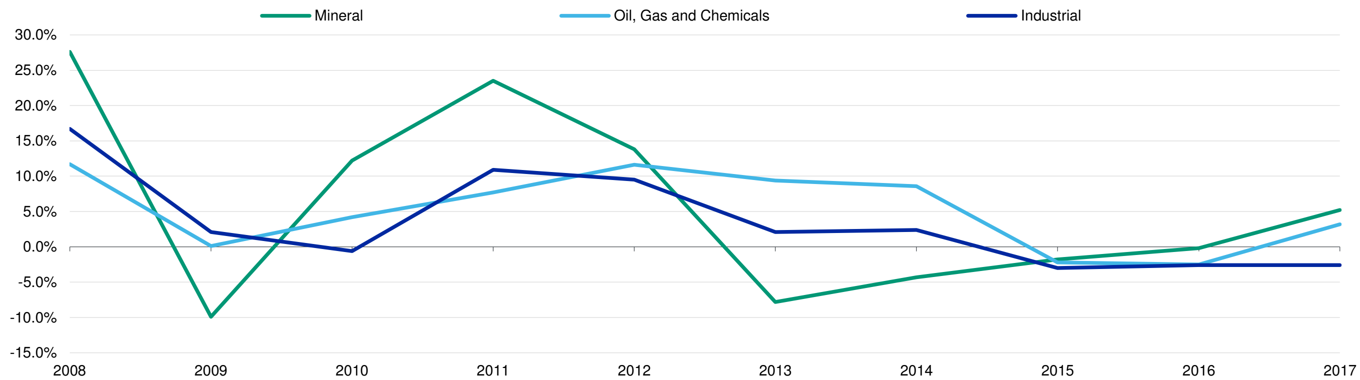
However we view the larger TIC companies such as SGS as well placed to respond to these challenges, with their scale, strength of reputation, global networks and long-term customer relationships enabling companies to invest in and commercialise new technologies. We also expect third party testing to gain share supported by its greater reliability and the complexity of digital supply chains.

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 potential need to share some of the industry margins with technology providers, may make the company's margin ambitions challenging.

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 and minerals & mining sectors. The OGC division represented approximately 18% of group revenues in 2017, with significant additional exposure to the sector within the industrial division (14% of 2017 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 2017 group revenues, and has shown significant volatility historically, as it has gradually moved upstream from trade inspection to geochemistry services for exploration.

Exhibit 4
Organic revenue growth for cyclical sub-sectors over the last 10 years



Source: Company

The OGC and minerals divisions recovered strongly in 2017 following prolonged downturns, since 2013 and 2014 respectively. In particular the minerals division grew revenues by 5.2% organically in 2017, after annual reductions averaging 3.5% since 2013. A recovery in upstream exploration and production supported growth of the OGC division where organic revenues grew 3.2% in 2017. However the industrial division continued to decline in 2017 driven by late-cycle effects as volume reduction and price pressure affect production plant maintenance contracts.

We expect oil and gas companies to maintain relatively stable / low growth in capital expenditure in 2018 and for the OGC division to maintain its low single digit revenue growth. We forecast the metals and mining sectors to remain stable in 2018 after the recovery in 2017 with stable prices, supported by a positive economic outlook across emerging markets in particular with solid growth in Chinese industrial production.

In total the OGC, minerals and industrials divisions represented 43% of 2017 revenues, a gradually declining proportion of the total group as the company continues to diversify and shift towards other sectors. The remaining business continued to record solid results, with approximately 6.2% organic revenue growth in 2017.

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

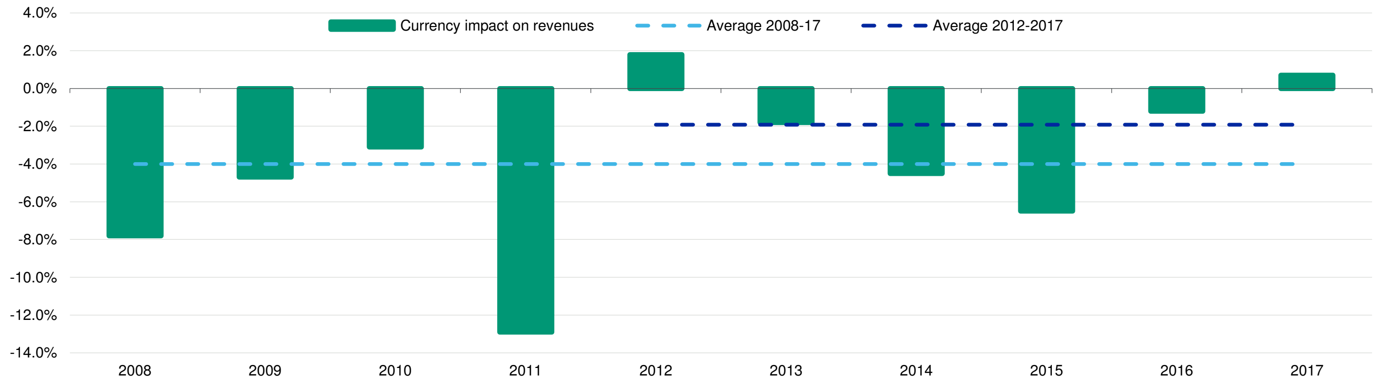
Currency movements have had a significant impact on historic trading results, as the company has very limited trading activity in CHF (approximately CHF20 million revenues and CHF100 million costs in 2014). Adverse currency movements have been experienced in each year since 2009 except for 2012 and 2017.

The largest currency exposures are to the euro (26% of 2017 revenues), US dollar (14%), and the Chinese renminbi (13%), 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 5

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

Annual revenue impact of currency movements 2008-2017



Source: Company presentations, Moody's analysis

In 2017 SGS benefited from favourable currency movements against the Swiss Franc, notably through the recovery of the Brazilian Real and the Euro, in total adding 0.7% to revenue growth.

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 1.9x at 31 December 2017, after adjusting for pensions and operating leases. The company retains significant levels of cash and marketable securities of approximately CHF1.4 billion at 31 December 2017 and net leverage is only 0.6x 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 79% and 85% of EBITDA over 2015-2017.

The company's financial policy remains conservative. The company plans to accelerate its M&A activity in the next three years, with a target of acquiring revenue of CHF1 billion over 2016 to 2020, of which approximately CHF300 million has been added through to 2017. However this remains low in the context of cash generation and the conservative balance sheet. Similarly 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 range 1.7x to 1.9x on a Moody's-adjusted basis.

Requirement for strong governance and control environment to protect reputation

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 including 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 CHF1.4 billion at 31 December 2017. It also has CHF600 million committed facilities available until 2021 which were undrawn as at 31 December 2017.

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.moodys.com for a copy of this methodology.

Exhibit 6

Business and Consumer Service Industry Grid [1][2]	Current 12/31/2017		Moody's 12-18 Month Forward View As of 1/23/2018 [3]	
Factor 1 : Scale (20%)	**Measure**	**Score**	**Measure**	**Score**
a) Revenue (USD Billion)	$6.6	Baa	$7-7.2	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	15.5%	Ba	15.5% - 16%	Ba
Factor 4 : Leverage and Coverage (40%)				
a) Debt / EBITDA	1.9x	A	1.7x - 1.9x	A
b) EBITA / Interest	15.8x	Aa	17x - 18x	Aa
c) RCF / Net Debt	43.4%	A	35% - 40%	Baa
Factor 5 : Financial Policy (10%)				
a) Financial Policy	A	A	A	A
Rating:				
a) Indicated Rating from Grid		A3		A3
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 12/31/2017.
[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 7

SGS SA Summary Financial Metrics and Projections

In CHF million	2015	2016	2017 [1]	2018 proj [2]	2019 proj [2]
INCOME STATEMENT					
Revenue	5,712	5,985	6,349	6,718	7,214
EBITDA	1,344	1,308	1,384	1,469	1,574
EBIT	916	884	957	1,020	1,105
Interest Expense	63	56	62	62	62
BALANCE SHEET					
Cash & Cash Equivalents	1,490	975	1,383	1,160	963
Total Debt	2,845	2,287	2,659	2,657	2,657
CASH FLOW					
Capital Expenditures	434	408	400	434	449
Retained Cash Flow (RCF)	376	493	550	587	641
RCF / Debt	13.2%	21.6%	20.7%	22.1%	24.1%
Free Cash Flow (FCF)	69	132	82	132	165
FCF / Debt	2.4%	5.8%	3.1%	5.0%	6.2%
PROFITABILITY					
% Change in Sales (YoY)	-2.9%	4.8%	6.1%	5.8%	7.4%
EBIT Margin %	16.0%	14.8%	15.1%	15.2%	15.3%
EBITDA Margin %	23.5%	21.9%	21.8%	21.9%	21.8%
INTEREST COVERAGE					
EBIT / Interest Expense	14.5x	15.7x	15.4x	16.4x	17.8x
EBITDA / Interest Expense	21.3x	23.3x	22.2x	23.7x	25.4x
(EBITDA - Capex) / Interest Expense	14.4x	16.0x	15.8x	16.7x	18.1x
LEVERAGE					
Debt / EBITDA	2.1x	1.7x	1.9x	1.8x	1.7x
Debt / (EBITDA - Capex)	3.1x	2.5x	2.7x	2.6x	2.4x
Net Debt / EBITDA	1.0x	1.0x	0.9x	1.0x	1.1x

[1] - Preliminary data incorporating Moody's estimates
[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™, Moody's projections

Ratings

Exhibit 8

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

Source: Moody's Investors Service

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