MOODY'S
INVESTORS SERVICE

CREDIT OPINION
30 January 2019

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 2018 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 2018) and the minerals and mining division (11% of 2018 revenues). Although the global economic outlook is softening, we continue to expect growth in the mid-single digits over the next 12-18 months driven by strong sector fundamentals.

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.

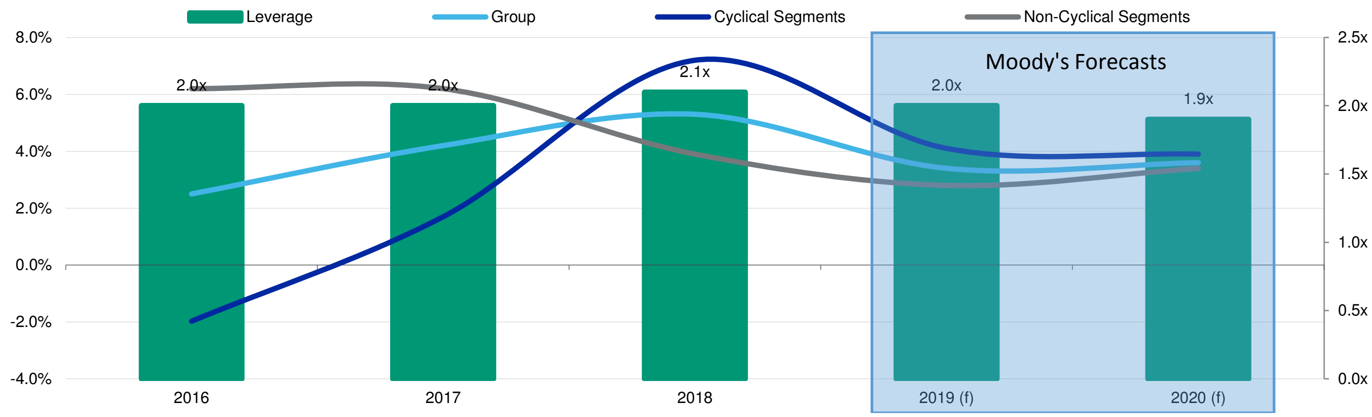
The company achieves high adjusted operating margins (15.7% in 2018, reported basis), and the company targets further margin growth of 1.3 percentage points through to 2020. Organic growth, and initiatives in procurement, productivity and digitalisation are expected to support this. However we envisage 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 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 2018 Moody's adjusted net leverage was 0.8x. Moody's-adjusted gross leverage was 2.1x and 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

Organic revenues are expected to benefit from a sustained recovery in cyclical segments

% 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) 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

	12/31/2013	12/31/2014	12/31/2015	31/12/2016	31/12/2017	[2]31/12/2018	[3] 31/12/2019F	[3] 31/12/2020F
Revenue (USD Billion)	$6.3	$6.4	$5.9	$5.9	$6.6	$7.0	$7.3	$7.7
EBITA Margin	17.5%	16.8%	16.9%	15.5%	15.7%	15.7%	16.0%	16.1%
Debt / EBITDA	1.3x	1.7x	2.1x	1.7x	2.0x	2.1x	2.0x	1.9x
EBITA / Interest	16.8x	16.3x	15.3x	16.7x	16.9x	16.4x	17.1x	18.0x
RCF / Net Debt	69.0%	60.7%	27.8%	37.6%	41.3%	37.1%	38.9%	37.7%

[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 2018 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 CHF18.1 billion as at 25 January 2019.

SGS operates a network of approximately 2,600 offices and laboratories worldwide and employs over 97,000 staff. In 2018 the company reported revenues of CHF6.7 billion and adjusted operating income of CHF1,050 million.

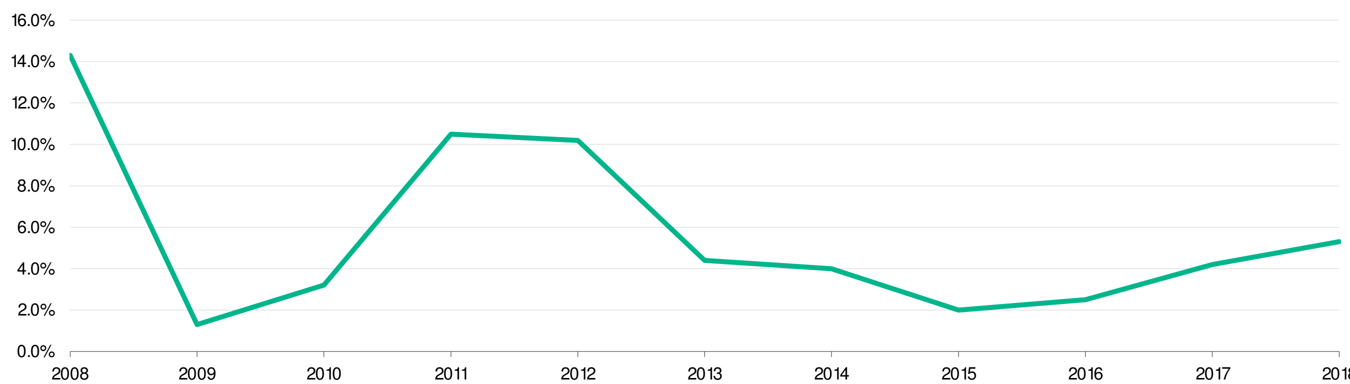
Detailed Credit Considerations

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



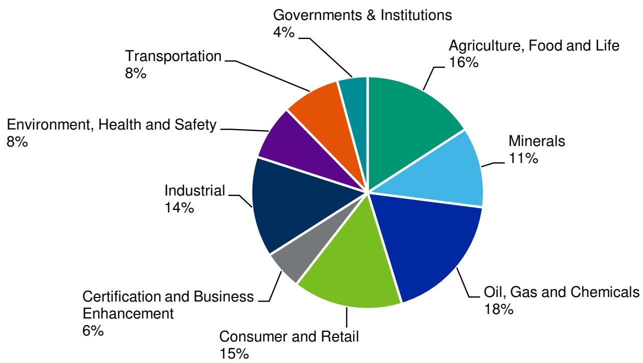
Source: Company

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, 2018



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 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. 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). Beyond the major players the market is highly fragmented with over 25,000 commercial laboratories as well as in-house and government-run operations.

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%, well ahead of group total (15.7%).

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.

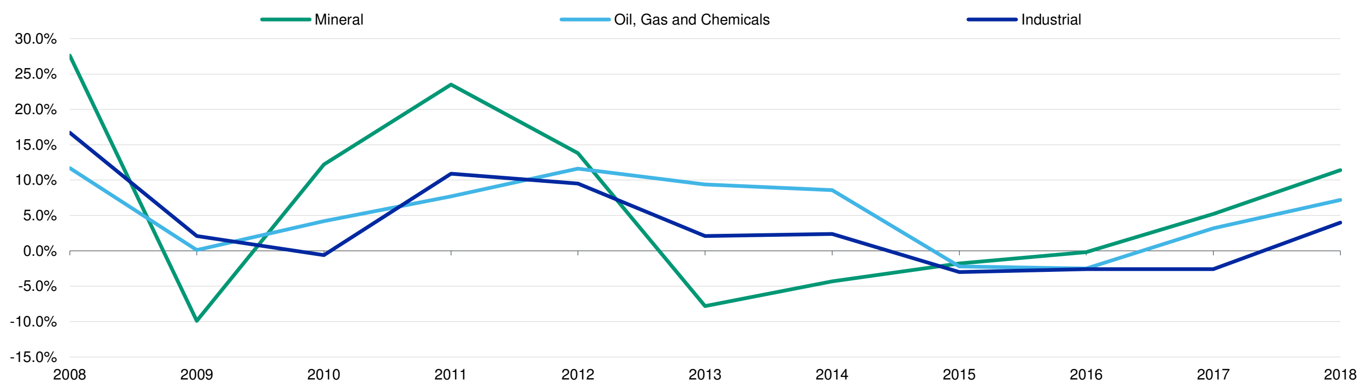
However we view the larger TIC companies such as SGS as well placed to respond to these challenges, with their scale, strength of reputation, global networks and long-term customer relationships enabling companies to invest in and commercialise new technologies. We also expect third party testing to 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 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 & mining sectors. The OGC division represented approximately 18% of group revenues in 2018, with significant additional exposure to the sector within the industrial division (14% of 2018 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 2018 group revenues, 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 and minerals divisions have continued their recovery during 2018, with 11.4% organic revenue growth at the minerals divisions and 7.2% in OGC in spite of the significant oil price contraction since Q4 2018. The industrial division recovered in 2018 with 4% organic growth, largely driven by testing activities and inspection services.

We expect that oil & gas companies in 2019 will continue to exercise spending discipline and focus on capital efficiency and for the OGC division to return to its low single digit revenue growth. We expect metal prices to soften during 2019 driven by softening global demand, hence moderating organic revenue growth for the division.

In total the OGC, minerals and industrials divisions represented 43.4% of 2018 revenues, a steady 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% organic revenue growth in 2018,with growth rates impacted by the transportation division where 2017 revenues were lifted by significant non-recurring contracts in the US.

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

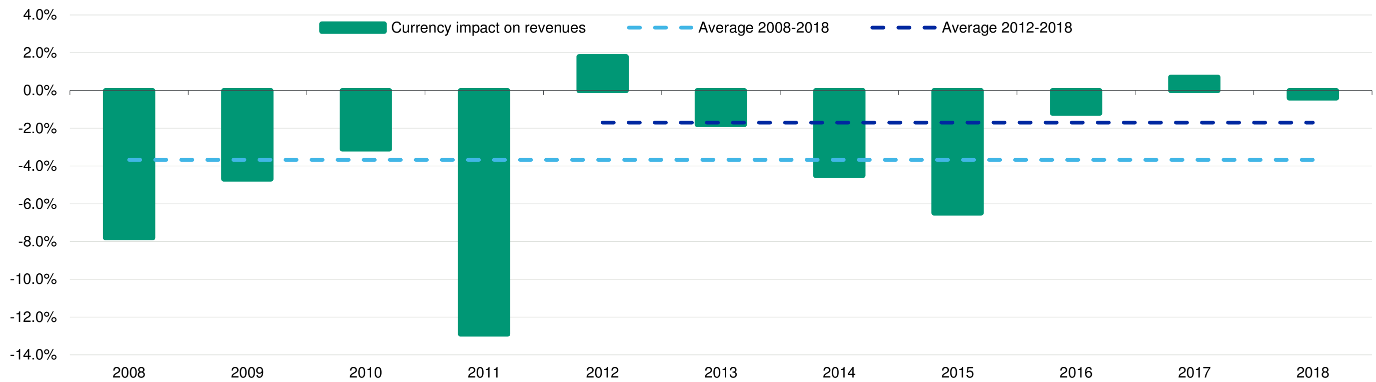
Currency movements have had a significant impact on historic trading results, as the company has very limited trading activity in CHF (representing less than 2% of revenue in 2018). Adverse currency movements have been experienced in each year since 2009 except for 2012 and 2017.

The largest currency exposures are to the euro (26.4% of 2018 revenues), US dollar (14.5%), and the Chinese renminbi (14.1%), 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 2018 SGS was impacted by currency depreciations against the Swiss Franc, notably Brazilian Real (-12.7%) and Russian Rouble (-7.1%), resulting in a 0.4% 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 2.1x at 31 December 2018 after adjusting for pensions and operating leases. The company retains significant levels of cash and marketable securities of approximately CHF1.8 billion at 31 December 2018 and net leverage is only 0.8x 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.

The company's financial policy remains conservative. The company plans to accelerate its M&A activity as part of its 2020 strategic plan, with a target of acquiring revenue of CHF1 billion over 2016 to 2020, of which approximately CHF300 million has been added through to 2018. However this remains low in the context of cash generation and the conservative balance sheet and it is partially offset by the potential proceeds from the disposal of already identified underperforming and non-core business with a combined revenue of CHF350 million.

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 2x range 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, 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 CHF1.8 billion at 31 December 2018. It also has CHF600 million committed facilities available until 2021 which were undrawn as at 31 December 2018.

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 7

Business and Consumer Service Industry Grid [1][2]	Current 12/31/2018		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)	$7.0	Baa	$7.0-7.7	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	15.7%	Ba	15.7-16.1%	Ba
Factor 4 : Leverage and Coverage (40%)				
a) Debt / EBITDA	2.1x	Baa	1.8x - 2.0x	A
b) EBITA / Interest	16.4x	Aa	17x - 18x	Aa
c) RCF / Net Debt	37.1%	Baa	35% - 40%	Baa
Factor 5 : Financial Policy (10%)				
a) Financial Policy	A	A	A	A
Rating:				
a) Indicated Rating from Grid		Baa1		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 8

SGS SA Summary Financial Metrics and Projections

In CHF million	2016	2017	2018 [1]	2019 proj [2]	2020 proj [2]
INCOME STATEMENT					
Revenue	5,985	6,349	6,706	7,033	7,381
EBITDA	1,357	1,433	1,520	1,608	1,684
EBIT	889	942	1,022	1,020	1,105
Interest Expense	61	56	64	66	66
BALANCE SHEET					
Cash & Cash Equivalents	975	1,383	1,752	1,534	1,355
Total Debt	2,423	2,840	3,239	3,239	3,239
CASH FLOW					
Capital Expenditures	452	480	458	480	495
Retained Cash Flow (RCF)	536	602	552	666	713
RCF / Debt	22.1%	21.2%	17.0%	20.6%	22.0%
Free Cash Flow (FCF)	131	86	120	145	184
FCF / Debt	5.4%	3.0%	3.7%	4.5%	6.2%
PROFITABILITY					
% Change in Sales (YoY)	4.8%	6.1%	5.6%	4.9%	4.9%
EBIT Margin %	14.8%	14.8%	15.2%	14.5%	15.0%
EBITDA Margin %	22.7%	22.6%	22.7%	22.9%	22.8%
INTEREST COVERAGE					
EBIT / Interest Expense	14.6x	16.9x	16.0x	15.5x	16.7x
EBITDA / Interest Expense	22.3x	25.8x	23.7x	24.4x	25.5x
(EBITDA - Capex) / Interest Expense	14.8x	17.1x	16.6x	17.1x	18.0x
LEVERAGE					
Debt / EBITDA	1.8x	2.0x	2.1x	2.0x	1.9x
Debt / (EBITDA - Capex)	2.7x	3.0x	3.1x	2.9x	2.7x
Net Debt / EBITDA	1.1x	1.0x	1.0x	1.1x	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 9

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

Source: Moody's Investors Service

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CLIENT SERVICES

Americas	1-212-553-1653
Asia Pacific	852-3551-3077
Japan	81-3-5408-4100
EMEA	44-20-7772-5454

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