MOODY'S
INVESTORS SERVICE

Credit Opinion: SGS SA

Global Credit Research - 11 Mar 2016

Switzerland

Ratings

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

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Key Indicators

[1]**SGS SA**

	12/31/2015	12/31/2014	12/31/2013	12/31/2012
Revenue (USD Billion)	**$5.9**	**$6.4**	**$6.3**	**$5.9**
EBITA Margin	**16.9%**	**16.8%**	**17.5%**	**17.6%**
Debt / EBITDA	**2.1x**	**1.7x**	**1.3x**	**1.5x**
EBITA / Interest	**15.3x**	**16.3x**	**16.8x**	**16.1x**
RCF / Net Debt	**33.9%**	**60.7%**	**69.0%**	**53.0%**

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

Note: For definitions of Moody's most common ratio terms please see the accompanying User's Guide.

Opinion

Rating Drivers

Strong long-term track record of growth through the cycle and positive long-term growth dynamics

Market leadership, global reach and sector diversity offsetting exposures to commodity sectors and capital investment cycles

Currency translation exposures particularly to depreciating emerging markets currencies

Cost saving opportunities offsetting price pressure in mature and cyclical segments

Slowdown in the Chinese market

Low leverage and solid liquidity

Corporate Profile

SGS Group (SGS or the company) is the global leader in the testing, inspection and certification (TIC) market. The company is headquartered in Geneva, Switzerland and is listed on the Swiss Stock Exchange. The company's market capitalisation was CHF16.1 billion as at 9 March 2016.

SGS operates a network of approximately 1,800 offices and laboratories worldwide and employs over 85,000 staff. In 2015 the company reported revenues of CHF5.7 billion and EBITDA of CHF1,144 million. Leverage based on Moody's-adjusted gross debt and EBITDA was 2.1x at 31 December 2015.

Rating Rationale

SGS's A3 issuer rating is supported by: 1) the long-term track record of positive organic growth and strong long-term growth fundamentals; (2) high levels of sector and geographic diversity; (3) the company's leading market position and market leading growth rates, profitability and sector diversification; and (4) the low leverage, high operational cash generation and solid liquidity profile.

It also reflects: (1) its exposure to oil and gas and minerals markets which are partially impacted by industry investment cycles and commodity prices; (2) the exposure to emerging market currencies and risks of ongoing currency depreciation against the Swiss franc; (3) higher levels of competition and price pressure within lower added value field testing and inspection services, offset by favourable shifts in revenue mix and cost saving potential; and (4) slowdown in the Chinese market.

DETAILED RATING CONSIDERATIONS

LONG-TERM TRACK RECORD OF POSITIVE ORGANIC GROWTH AND STRONG LONG-TERM GROWTH FUNDAMENTALS

The company has delivered highly stable performance over the cycle with positive organic growth in each of the last 10 years, including organic growth of 1.3% in 2009. This reflects the 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. Whilst SGS is vulnerable to downturns in specific industries, this is mitigated by its broad diversity and the fundamental growth trajectory of TIC services.

The medium-term industry outlook remains positive. Growth continues to be driven by increasing regulation and regulatory demand for independent testing, increased customer focus on regulatory compliance, growth in outsourcing, increasing product standards, growth of middle class consumption in emerging markets, increasing global trade, GDP growth and export volumes. This is partly offset by the current weak oil and gas and commodity markets, for which we do not expect significant recoveries in the near term. The continued commercialisation of testing of China is also a potential growth driver as 80% of laboratories remain state-owned, although the pace of change remains gradual.

These factors have historically generated underlying revenue growth in the mid to high single digits. We expect growth in SGS's markets in the range of 2-3% p.a. in the near term, due to the more challenging conditions in oil and gas and minerals sectors and slowdown in the Chinese market. However we consider the fundamental growth drivers remain in place and support longer term organic annual revenue growth rates in the mid-single digits.

HIGH LEVELS OF SECTOR AND GEOGRAPHIC DIVERSITY

SGS is organised as 9 divisions operating across a diverse range of sectors and geographies. Revenues for 2015 are spread across Europe, Middle East and Africa (EMEA) (44.7%), Asia Pacific (30.2%) and Americas (25.1%). 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. Customer concentration is very low with the largest single customer representing 1.4% of 2014 revenues and top 20 representing only 10.4%. The diversity of revenues has enabled the company to achieve long-term positive organic growth at a group level with relatively limited exposure to more cyclical capital investment cycles. This was demonstrated in 2015 when organic revenue growth of 2.0% was achieved despite the slowdown in oil, gas and commodities markets.

LEADING MARKET POSITION AND MARKET LEADING GROWTH RATES, PROFITABILITY AND DIVERSIFICATION

SGS is the global leader in the TIC market, with the highest levels of growth, profitability and sector diversity. Bureau Veritas and Intertek (both unrated) 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) (all unrated). 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 estimates 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.

EXPOSURE TO OIL AND GAS AND MINERALS MARKETS

Whilst there is a broad sector diversity SGS is exposed to certain commodity markets, in particular in the oil and gas and mining sectors. Oil and gas revenues represent approximately 27% of group revenues, which is spread across the entire value chain from exploration and production, distribution, refining and retail. Approximately 4% of group revenues are derived from upstream exploration and production activities which are more exposed to variations in the oil price. Revenues across the remainder of activities are significantly more stable, and although the oil majors are expected to put continued pressure on suppliers across their operations, SGS benefits from greater stability of production volumes and also a level of upside from increased trading volatility.

In 2015 the company's OGC division showed an organic revenue decline of 2.2% as a result of declines in exploration activity. In addition the Industrial Services division is partially exposed to new oil and gas plant installation and this was impacted by reductions in sector capital expenditure, posting a 3% organic revenue decline in 2015. In total revenues across these two divisions fell by just below CHF60 million organically, or approximately 1% of total group revenues and this performance is consistent with the company's stated low exposure to the upstream activities in oil and gas.

The Minerals Services division shows greater volatility, as it has gradually moved upstream from trade inspection to geochemistry services for exploration. Organic revenue fell by 1.8% in 2015 following larger declines in 2013 and 2014 and reflecting continued declines in mineral prices in the year.

However the Minerals Services division represents only 9.8% of 2015 group adjusted EBIT and the division's performance has been offset by growth in other segments. Total organic revenue growth across the remaining divisions (excluding OGC, Industrial Services and Minerals Services) was slightly above 6% in 2015, compared to approximately 5% in 2014, in line with long term market trends and the reflecting strong performances in environment, automotive and government-related testing.

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 with very limited 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. The appreciation of the Swiss franc following the removal of its euro peg in January 2015 gave rise to a particularly high adverse effect on revenues of 6.5% in 2015.

The largest currency exposures are to the euro (26% of 2015 revenues), US dollar (14%), and the Chinese renminbi (13%), and around half of currency flows are in emerging markets. The high emerging markets exposure is likely to give rise to continued adverse currency effects given the higher inflation rates in these economies. A basket of emerging market economies shows inflation running in the mid 4% area over the last three years, with a resulting impact on currency depreciation of emerging markets currencies against the Swiss franc. The company seeks to mitigate these risks through both inflation and currency indexation in a proportion of its contracts. We estimate that SGS will continue to experience currency depreciation at an average rate of 1-2% per annum.

COST SAVING OPPORTUNITIES OFFSETTING PRICE PRESSURE IN MATURE AND CYCLICAL

SEGMENTS

SGS achieved stable margins in 2015, with a reported adjusted operating margin of 16.1%. This has followed a period of modest margin contraction since 2010 driven mainly by reductions in activity and operational leverage within the OGC and Minerals Services divisions and higher price pressure in more mature markets and field testing activities. In 2015 the company was able to offset these effects by restructuring its cost base and through favourable mix effects, particularly through faster growth in emerging markets.

In 2015 SGS announced plans to streamline its support functions through the creation of shared service centres. It also has identified opportunities for savings through centralised procurement, with the combined annual impact of these initiatives amounting to CHF100 million by 2017. We expect operating margin to be stable in 2016 and to grow thereafter as faster growth in higher margin regions and activities, alongside the cost saving initiatives, more than offset price pressures in field testing.

SLOWDOWN IN THE CHINESE MARKET

SGS's activities in China represent approximately 13% of group revenues and a higher proportion of EBITDA given its weighting towards higher margin consumer testing and stronger emerging markets margins. The slowdown in China may reduce the company's growth and whilst our central case anticipates a gradual slowdown there are downside risks of a more severe decline.

In mitigation SGS retains a very broad geographic diversity, and in addition its activities in China are spread across a wide range of activities. Approximately 40% of its business relates to the domestic market, and whilst local consumption could be dampened, the core drivers of an expanding middle class and greater demand for higher product standards is expected to sustain growth. In addition SGS is active in a wide range of segments beyond consumer testing and has delivered strong growth in agricultural, transportation and industrial sectors.

LOW LEVERAGE AND HIGH OPERATIONAL CASH GENERATION

Leverage is low with Moody's-adjusted gross leverage of 2.1x at 31 December 2015, after adjusting for pensions and operating leases. The company retains significant levels of cash and marketable securities of over CHF1.7 billion at 31 December 2015 and net leverage is only 0.8x on a Moody's adjusted basis. In 2015 the company issued bonds of CHF550 million the proceeds of which will be utilised to repay 2016 debt maturities of CHF492 million and to partially support the company's share buyback programme. Accordingly we expect gross leverage to reduce in 2016 to approximately 1.7x (Moody's adjusted) following the debt repayment, with net leverage increasing above 1x as cash is utilised for the share buyback programme. These levels remain moderate given the strength of company's long-term performance.

SGS generates a relatively high level of cash with operating cash flow, prior to working capital and capital expenditure, of around 70-80% of EBITDA from 2009-2015. We expect some improvements in cash flows in 2016 as the CHF103 million one-off pension fund contribution in 2015 is not repeated, and working capital and capital expenditure levels remain stable.

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 have been relatively limited and isolated in nature.

Liquidity

The company has a solid liquidity position with balance sheet cash and marketable securities of CHF1.7 billion at 31 December 2015. It also has CHF600 million committed facilities available until 31 December 2017.

We expect cash balances to reduce in 2016 through the repayment of bonds at maturity and through its share buyback programme. We expect SGS to maintain minimum cash balances of approximately CHF0.75 - 1 billion over 2016 which results in total headroom including committed facilities and excluding cash in subsidiaries of circa CHF1.0 - 1.25 billion.

Rating Outlook

The stable outlook reflects primarily the very 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 sufficient liquidity.

What Could Change the Rating - Up

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.

What Could Change the Rating - Down

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.

Other Considerations

The principal methodology used in rating SGS was the Business and Consumer Service Industry Rating Methodology published in December 2014. Please see the Credit Policy page on www.moodys.com for a copy of this methodology.

Rating Factors

SGS SA

Business and Consumer Service Industry Grid [1][2]	**Current FY 12/31/2015**		[3]**Moody's 12-18 Month Forward ViewAs of 3/3/2016**	
Factor 1 : Scale (20%)	**Measure**	**Score**	**Measure**	**Score**
a) Revenue (USD Billion)	$5.9	Baa	$5.9	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	16.9%	Ba	17% - 17.5%	Ba
Factor 4 : Leverage and Coverage (40%)				
a) Debt / EBITDA	2.1x	Baa	1.6x - 2x	A
b) EBITA / Interest	15.3x	Aa	16x - 18x	Aa
c) RCF / Net Debt	33.9%	Baa	30% - 35%	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		A3

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. [2] As of 12/31/2015; Source: Moody's Financial Metrics [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

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