

Global Credit Research - 12 Mar 2015

Switzerland

Ratings

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

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Key Indicators

[1]SGS SA	12/31/2014	12/31/2013	12/31/2012
Revenue (USD Billion)	\$6.4	\$6.3	\$5.9
EBITA Margin	17.5%	18.1%	17.9%
Debt / EBITDA	2.0x	1.7x	1.6x
EBITA / Interest	11.0x	11.6x	13.3x
RCF / Net Debt	39.1%	43.1%	40.8%

[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

Robust business with positive long-term growth dynamics

Market leadership, global reach and sector diversity

Low leverage and solid liquidity

Element of exposure to commodity sectors and related capital investment cycles

Currency translation exposures particularly to depreciating emerging markets currencies

Price pressure in lower added value field testing segments

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 CHF14.7 billion as at 9 March 2015.

SGS operates a network of over 1,650 offices and laboratories worldwide and employs over 80,000 staff. In the year ended 31 December (FY) 2014 the company reported revenues of CHF5.9 billion and EBITDA of CHF1,245 million. Leverage based on Moody's-adjusted gross debt and EBITDA for FY2014 was 2.0x.

Recent Developments

On 12 March 2015, we assigned a first-time A3 long-term issuer rating to SGS. The outlook on the rating is stable.

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; and (3) higher levels of competition and price pressure within lower added value field testing and inspection services.

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 high at around 95% 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, growth in outsourcing, increasing product standards, growth of middle class consumption in emerging markets, increasing global trade, GDP growth and export volumes. The continued commercialisation of testing of China is also a significant component of growth as 80% of laboratories remain state-owned. These factors have historically generated underlying growth in the mid to high single digits and we expect growth SGS's markets in the range 5-6% CAGR.

HIGH LEVELS OF SECTOR AND GEOGRAPHIC DIVERSITY

SGS is divided into 10 divisions operating across a diverse range of sectors and geographies. Revenues for FY2014 are spread across Europe, Middle East and Africa (EMEA) (46.0%), Asia Pacific (29.6%) and Americas (24.4%). 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 FY2014 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.

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 OGC (the company estimates approximately 30% global market share in FY2014), 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.

LOW LEVERAGE AND HIGH OPERATIONAL CASH GENERATION

Leverage is low with Moody's-adjusted gross leverage of 2.0x at 31 December 2014, after adjusting for pensions and operating leases. The company retains significant cash balances of over CHF1.3 billion at 31 December 2014 and net leverage is only 1.1x on a Moody's adjusted basis and 0.3x on a reported basis. We expect gross leverage to increase in 2015 to slightly above 2.0x (Moody's adjusted) as a result of adverse currency movements following the removal of the Swiss franc's Euro peg. We expect net leverage to increase to around 1.4x in 2015 (Moody's adjusted) due to currency movements and the impact of the company's proposed 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 capex, of around 70-80% of EBITDA from 2009-2014. We expect some improvements in cash flows over the next 1-2 years as capital expenditure levels are reducing following a period of increased investment. We also note the objective of the company to increase its focus on working capital management.

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 although the current depressed oil price is causing some stress within the refinery segment.

The company's oil, gas and chemicals services (OGC) division remained robust in 2009, with positive 0.1% organic growth during which time average oil prices fell by 36%. Since 2009 the division has expanded its activities in upstream services and the impact of the current oil price downturn is expected to be more significant in the current year. However the effect is likely to remain limited: a 25% cut in upstream business would reduce revenues by approximately CHF60 million sales, representing approximately 1% of group revenues.

The minerals service division shows greater volatility, as it has gradually moved upstream from trade inspection to geochemistry services for exploration. Organic revenue growth has swung from a low of -9.9% in 2009 and +23.5% in 2011 and the division has reported organic revenues declines in the last two years following a 47% cut in global exploration capex in the industry, as well as a 4.6% fall in reported adjusted operating margin.

Mineral commodity prices have started to stabilise since mid-2014 and this has been evident in recent results, with organic revenue declines improving to -1.1% in the second half of 2014 compared to -7.6% in the first half. The minerals division represents only 10.4% of FY2014 group adjusted EBIT and the division's performance has been offset by growth in other segments.

EXPOSURE TO EMERGING MARKET CURRENCIES AND RISKS OF ONGOING CURRENCY DEPRECIATION AGAINST THE SWISS FRANC

Currency movements have had a significant impact on historic results with very limited trading in CHF (approximately CHF20 million revenues and CHF100 million costs in FY2014). 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 will have a further impact on FY2015 revenues of approximately 10% at current spot rates.

The largest currency exposures are to the euro (28% of FY2014 revenues), USD 14%, and the Chinese renminbi 11%, 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 two years, with a resulting

impact on currency depreciation of emerging markets currencies against the Swiss franc.

We estimate that inflation effects accounted for approximately 2.5% of the annual organic revenue growth reported in 2013 and 2014. Part of this benefit will be lost through currency depreciation although the company seeks to limit the impact through both inflation and currency indexation in a proportion of its contracts. We estimated that SGS will continue to experience currency depreciation at an average rate of 1-2% per annum.

HIGHER LEVELS OF COMPETITION AND PRICE PRESSURE WITHIN LOWER ADDED VALUE FIELD TESTING AND INSPECTION SERVICES

SGS has seen a slight decline in profit margin over the last four years, with reported adjusted operating margin reducing from 17.8% in 2010 to 16.1% in 2014. Several different factors contribute to this: (1) price pressure in field testing activities which represent between 20% and 80% of divisional revenues; (2) competition within mature markets in Europe and North America; and (3) price pressure and operational leverage in cyclical sectors of oil and gas and minerals. This is partly offset by growth in higher added value upstream services, and faster growth in higher margin emerging markets.

Outside of OGC and minerals segments reported adjusted operating margins are relatively stable, reducing by only 0.5% since 2010. Whilst margins trends are somewhat cyclical, the oil and gas business has seen margin declines during a period of expansion as it remains relatively highly exposed to trade-related field testing, representing circa 40% of divisional revenues. We would expect more significant margin declines at a group level in 2015 due to the impact of the reduced oil price on the OGC division, and very low margin compression thereafter, as the company continues to focus on higher added value services and emerging markets.

Liquidity

The company has a solid liquidity position with balance sheet cash of CHF1,341 million at 31 December 2014. This includes CHF356 million of cash held within subsidiaries. It also has CHF600 million committed facilities available until 31 December 2017.

The company plans to partially distribute its cash balances through the CHF750 million share buyback programme during 2015 and 2016. CHF492 million of its existing bonds mature in 2016, which we expect to be refinanced by further bond issues. We expect SGS to maintain minimum cash balances of approximately CHF500-750 million through to 2016 which results in total headroom including committed facilities and excluding cash in subsidiaries of circa CHF750 - 1,000 million.

Rating Outlook

The stable outlook reflects primarily the very solid positioning in the A3 category and Moody's view 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.moody.com for a copy of this methodology.

Rating Factors

SGS SA

Business and Consumer Service Industry Grid [1][2]	Current FY 12/31/2014	
Factor 1 : Scale (20%)	Measure	Score
a) Revenue (USD Billion)	\$6.4	Baa
Factor 2 : Business Profile (20%)		
a) Demand Characteristics	A	A
b) Competitive Profile	A	A
Factor 3 : Profitability (10%)		
a) EBITA Margin	17.5%	Ba
Factor 4 : Leverage and Coverage (40%)		
a) Debt / EBITDA	2.0x	Baa
b) EBITA / Interest	11.0x	A
c) RCF / Net Debt	39.1%	Baa
Factor 5 : Financial Policy (10%)		
a) Financial Policy	A	A
Rating:		
a) Indicated Rating from Grid		Baa1
b) Actual Rating Assigned		

[3]Moody's 12-18 Month Forward ViewAs of 3/5/2015		
Measure		Score
\$5.7 - \$6		Baa
A		A
A		A
17% - 17.5%		Ba
2x - 2.2x		Baa
11x - 12x		A
23% - 26%		Ba
A		A
		Baa1
		A3

[1] All ratios are based on 'Adjusted' financial data and incorporate Moody's Global Standard Adjustments for Non-Financial Corporations. [2] As of 12/31/2014; 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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