Independent Asset Management

June 2023

Givaudan

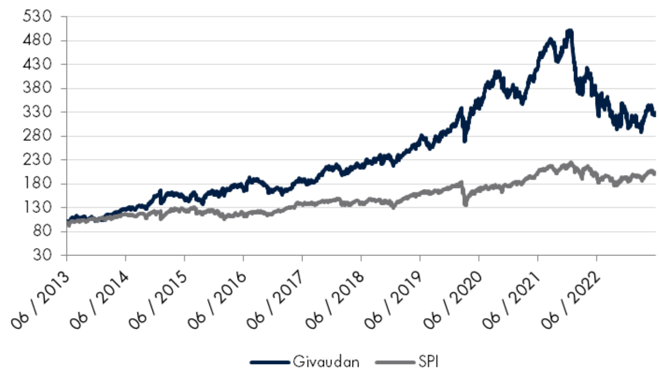
Market profile

Country	Switzerland
Sector	Basic Materials
Market cap (CHF bn)	28
52-week high / low (CHF)	3689 / 2672

Key metrics (CHF)

	2022	2023e	2024e
EPS	92.5	99.3	112.0
PE	30.6x	30.5x	27.1x
Dividend Yield	2.3%	2.2%	2.4%

Evolution of stock price with respect to benchmark (rebased)



Executive summary

Together with their customers Givaudan delivers food experiences, crafts inspired fragrances and develops beauty and wellbeing solutions that make people look and feel good. From your favorite drink to your daily meal, from prestige perfumes to laundry care, Givaudan's products help people live happier and healthier lives. The company's goal is to create these products in a way that respects natural resources and the environment.

The Company has two business activities: Taste & Wellbeing (54% of company's sales) and Fragrance & Beauty (46% of sales). 56% of their revenues come from mature markets, and 44% from high growth markets. 45% of their sales go to multinational customers and 55% to local and regional customers (which grow faster).

The company's business model is quite unique. Givaudan does not sell run of the mill fragrances or flavors but works with their clients on a bespoke solution. Typically, products sold by Givaudan represent 0.5—2% of an end product's total costs in flavors and consumer fragrances, and 4—6% in fine fragrances. Givaudan's business has a very high barrier to entry, technically and from a logistic standpoint of view.

Givaudan is one of the rare Swiss companies to never have reported a negative organic revenue growth since its initial public offering in 2000. This was much appreciated by investors who have driven Givaudan's valuation to extraordinary levels (45x next 12 months P/E) during the COVID pandemic. We believe that valuation still has to come down somewhat before the stock finds its attractiveness again.

Givaudan

Daniel Pfund, Senior Financial Analyst **June 2023**

Company description

Together with their customers Givaudan delivers food experiences, crafts inspired fragrances and develops beauty and wellbeing solutions that make people look and feel good. From your favorite drink to your daily meal, from prestige perfumes to laundry care, Givaudan's products help people live happier and healthier lives. The company's goal is to create these products in a way that respects natural resources and the environment.

Figure 1 showcases Givaudan's end customers products.

The Company has two business activities, Taste & Wellbeing and Fragrance & Beauty, reflecting Givaudan's purpose of creating for happier, healthier lives, with love for nature.

Fig.1: Givaudan's products are used in a multitude of industries
Source: Company data, IAM research

Taste & Wellbeing (54% of total group sales)

With an expanded portfolio of products across flavors, taste, functional and nutritional solutions and a deep knowledge of the food ecosystem, Givaudan's passion is to collaborate with customers and partners to develop game-changing innovations in food and beverages. This activity is split into four divisions: Beverages (35% of category sales), Dairy (12%), Savoury (37%), and Sweet Goods (16%).

Fragrance & Beauty (46% of group sales)

The artistry of Givaudan's perfumers encompasses a myriad of passionate scented stories for brands everywhere. The group's collections of beauty innovations push industry limits by inspiring and empowering customers with tailored products to enhance their wellbeing. This activity

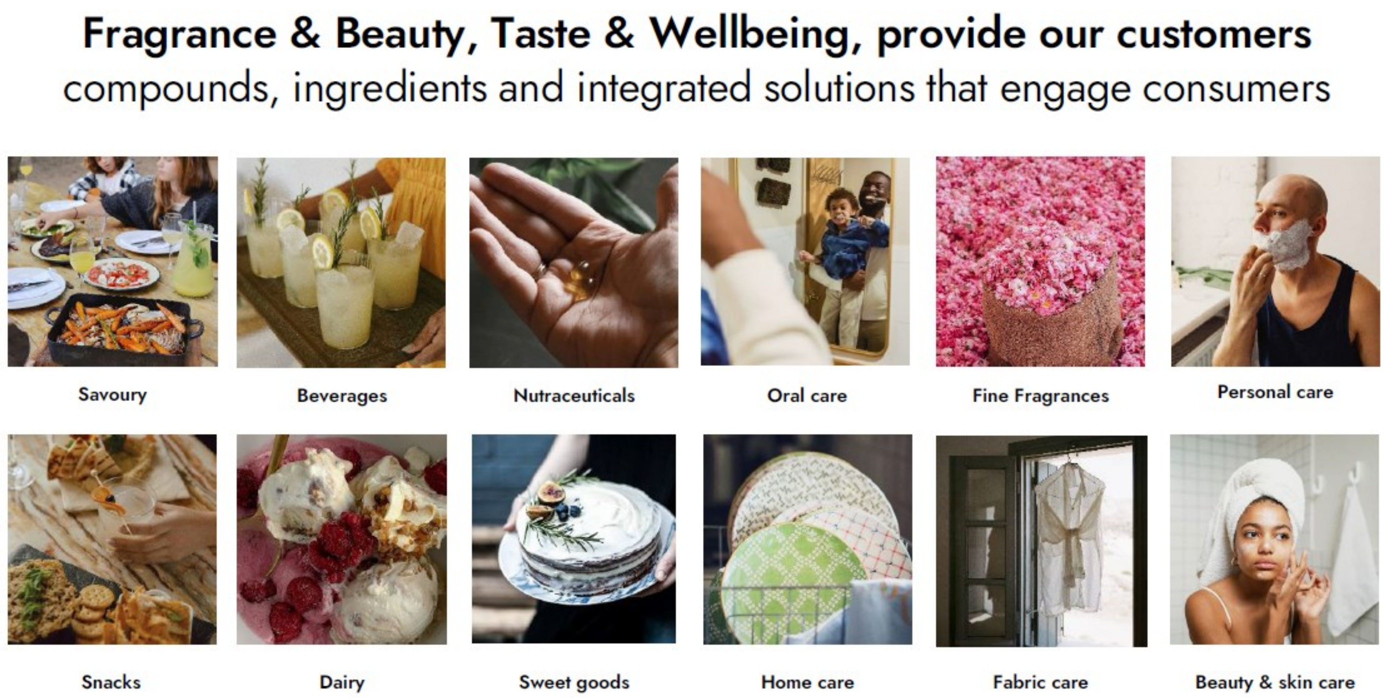
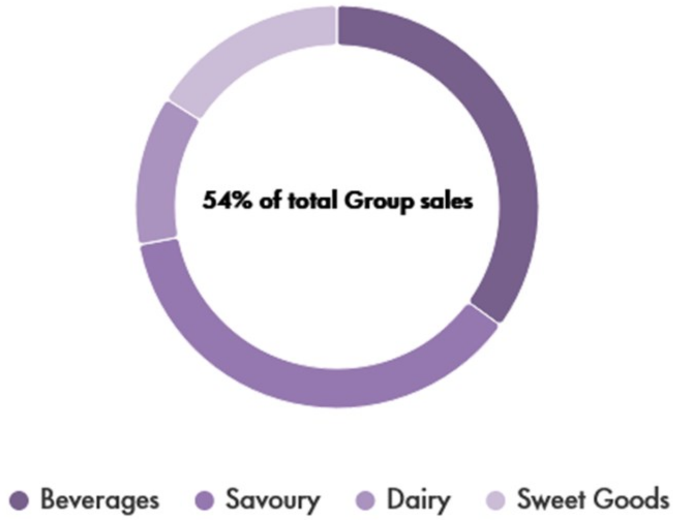


Fig.2 : Taste & Wellbeing breakdown

Source: Company data, IAM research



is split into three divisions: Consumer Products (65% of category sales), Fine Fragrances (20%), Fragrance Ingredients and Active Beauty (15%).

In 2022, Givaudan had sales of over CHF 7.1 billion. The company has 78 production sites worldwide, is present on all continents, and employs over 16 thousand people. The group is one of Switzerland's 20 biggest listed companies in terms of market capitalization.

Working in the business-to-business market, Givaudan offers its products to global, regional, and local food, beverage, consumer goods, fragrance, and cosmetics companies. 45% of their sales go to multinational customers and 55% to local and regional customers.

History of the company

Xavier Givaudan (1867-1966) founded Givaudan in 1895 with his brother Léon as a perfumery company in Lyon. While Léon set up his shop in Zurich, Xavier, a talented pharmacist, kept his pharmaceutical factory in Lyon. In 1898, Givaudan moved its headquarters to Vernier, Geneva. The closeness to France attracted trained perfumers from Grasse, Paris, or Lyon.

When World War I broke out, Xavier moved to Vernier to temporarily take over the business as Léon was sent to the front lines in France. Xavier never left Geneva. After Léon's passing, he continued to manage the business alone.

In 1946 Givaudan opened a perfumery school, which trained a third of the world's creative perfumers. Givaudan acquired Ersolko in 1948, which transitioned Givaudan into the flavor industry.

At the age of 97, Xavier Givaudan decided to sell his company to Hoffmann-La Roche in 1963.

In 1964, Roche acquired one of Givaudan's competitors, Roure. Roure was founded during 1820 in Grasse (France) and created the first designer perfume in 1937: Shocking for Schiaparelli.

In 1997, Givaudan-Roure acquired another flavor company: Tastemaker, based in Cincinnati, Ohio. The merger made Givaudan the largest flavor company in the world.

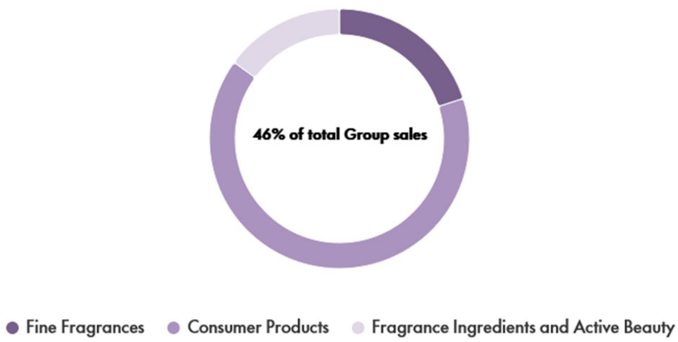
In 2000, Givaudan-Roure was spun off by Roche as Givaudan and listed on the Swiss Stock Exchange, where it is now part of the SMI.

In 2002, Givaudan acquired FIS, the flavors division of Nestlé, for which Nestlé received a 10% stake in the company. Nestlé later sold its shares of Givaudan in a private placement in 2013 for 1.2 billion CHF.

In 2006, Givaudan announced the acquisition of Quest International, making it the global leader in both fine fragrances and consumer products. The acquisition of Quest International boosted Givaudan's sales by 42% in 2007.

Fig.3 : Fragrance & Beauty breakdown

Source: Company data, IAM research



Geographic exposure

In 2022, 37% of sales were in Europe, Africa, Middle East, 26% of sales were in North America, 25% of sales were in Asia Pacific and 12% of sales were in Latin America.

56% of their revenues come from mature markets, and 44% from high growth markets.

Industry Overview & Competitive positioning

A global industry leader creating game changing innovations in food and beverage as well as inspiring creations in the world of scent and beauty, Givaudan operates in the expanded market space of flavor & taste, functional & nutrition ingredients, fragrance & beauty, worth CHF 42 billion. Their main competitors are Symrise, DSM-Firmenich and IFF. With sales of CHF 7.1 billion, Givaudan's market share is only 16.9%, as the market remains fragmented. With the successful merger of DSM and Firmenich in May of 2023, the newly combined group (aptly named DSM-Firmenich) will overtake Givaudan in terms of revenues.

Givaudan is present in high growth markets. Asia Pacific, Latin America, and Eastern Europe, already account for 44% of their annual sales and this is expected to continue increasing year on year. Market growth is expected to be much higher due to urbanization, changes in lifestyle and the increase in consumers' disposable income. The group has a dedicated presence with creation and production facilities in all key regions to fully capture this potential.

The company's business model is quite unique. Givaudan does not sell run of the mill fragrances or flavors but works with its clients on a bespoke solution. This means that each creation is unique, and Givaudan keeps the formula proprietary, locking the customer long-term. Indeed, customers don't want to take the risk of changing a flavor or fragrance, which is often associated with their product. They accept this position, as in fine, the amount paid to Givaudan reflects only a minor portion of the final price of that product. Typically, products sold by Givaudan represent 0.5—2% of an end product's total costs in flavors and consumer fragrances, and 4—6% in fine fragrances. Givaudan's business has a very high barrier to entry, technically and from a logistic standpoint of view. Clients cannot afford to be out of stock of such a valuable ingredient for their end products, and don't want to take the risk of purchasing from a small unknown supplier.

Givaudan's added value lies in constant research and development (R&D) tied to the deep understanding of their clients' needs. The group spent an impressive CHF 522 million in 2022 on R&D, representing 7.3% of sales. Givaudan can process over 300'000 customer submissions per year, and only 15% of their portfolio is up for review annually due to the life cycle of products.

Financial analysis

Growth

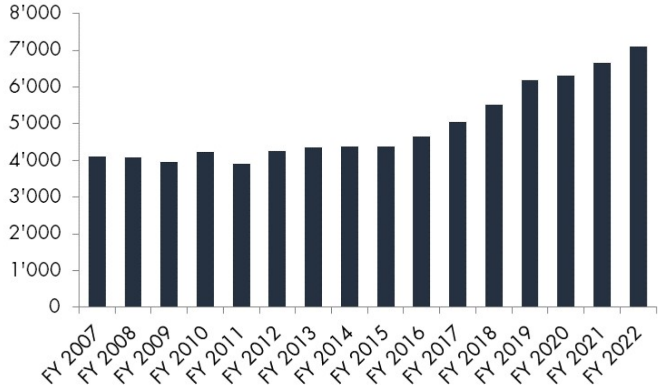
The chart in figure 4 shows Givaudan's revenues over the last 15 years. The compound annual growth rate (CAGR) over the whole period is 3.7%. But we can see that revenues have really accelerated since 2018, and the CAGR for the last 5 years is an impressive 7.1%. Of course, this is not all organic growth, as we will discuss in the balance sheet section.

Mid-term guidance is for sales to grow in the range of 4.0% to 5.0% during the period 2021-2025 (on a like for like basis, meaning without acquisitions).

Givaudan is one of the rare Swiss companies to never have reported a negative organic revenue growth since its initial public offering in 2000. Even during the great financial crisis, Givaudan was able to grow its revenues organically in 2009.

Fig.4: Givaudan's revenues over time

Source: Company data, IAM research



The non-cyclical, defensive, profile of Givaudan's top line is due to the end products for which the fragrances and flavors are used. These products are consumed even in more difficult times. This is the case for products such as detergents, shampoos, beverages, ready-made meals or noodle soup. The only cyclical areas in the Givaudan portfolio are fine fragrances (around 8% of the group's total revenues), and food services (end products in restaurants and hotels, approximately 7% of total revenues).

Longer term, Givaudan is exposed to mega-themes in the consumer staples segment, such as meat substitution (plant-based foods). Givaudan already has a strong market position in this segment with revenue of around CHF 150 million (about 2% of total revenue), growing at a double digit rate.

Margins

The chart in figure 5 shows Givaudan's operating margin over the last 10 years. We can see that it remains stable in a range of 15-18%. The drop in 2018 and 2019 was due to the Naturex acquisition and integration. It is interesting that Givaudan's management is not too focused on operating margin, but rather prefers to give guidance on free cash flow as a percentage of sales. One reason might be that clients would not be too happy to participate in growing Givaudan's margins. Another reason is that financially, free cash flow is more relevant than purely operating margins (even if they are related, free cash flow considers capital expenditures).

Dividends

Fig.5 : Givaudan's operating margin over time

Source: Company data, IAM research

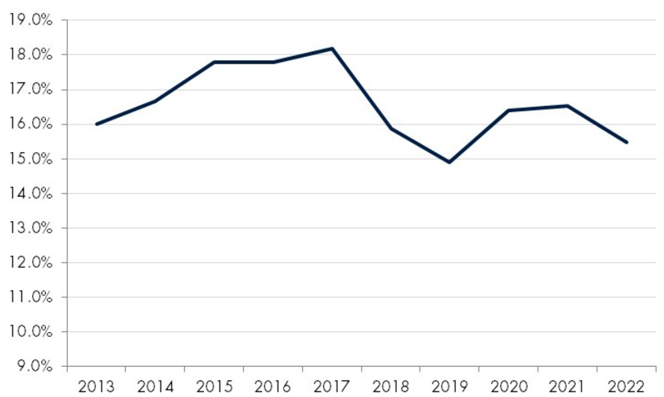
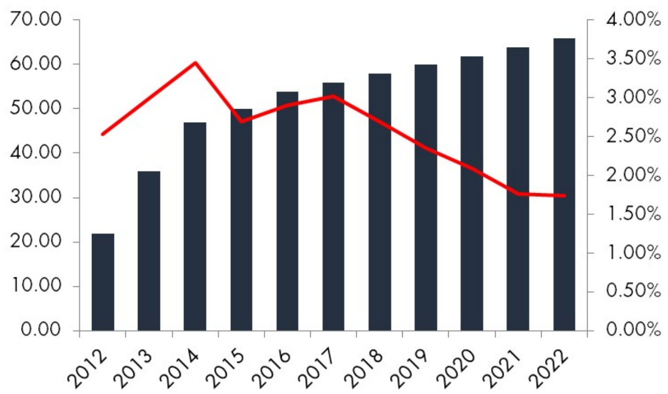


Fig.6 : Givaudan's dividend per share and yield (rhs)

Source: Company data, IAM research



The chart in figure 6 shows Givaudan's dividend per share over the last 10 years. Dividends have monotonically increased, but this does not imply that Givaudan has a progressive dividend policy in place. Indeed, Givaudan never guided or has explicitly given guidance on dividend policy. In fact, in 2009, the dividend decreased year over year. It seems like Givaudan is more inclined to maintain a tight payout ratio of 75-80%. The fact that the dividend has increased over the years is hence related to the non-cyclicality of Givaudan's earnings.

We would like to remind investors that dividends are not a tax efficient way to return capital. Indeed, the dividend comes from money the company already paid taxes on, as it cannot deduct it as an expense. Afterwards, the investor is also taxed on this same amount (35% at source), so there is a double taxation of the distributed dividend. In contrast, share buybacks are a more efficient way to return capital back to shareholders, as they are only taxed at the company level.

Free Cash Flow

Free cash flow (FCF) is an essential component of any company and can be considered its life blood. Free cash flow refers to the cash a business generates after is has accounted for the outflow of money towards operations and maintaining capital assets. It is from FCF that the company can decide to either reimburse debt (capital allocation), make acquisitions (mergers & acquisitions),

Fig.7 : Givaudan's cash flow over time

Source: Company data, IAM research

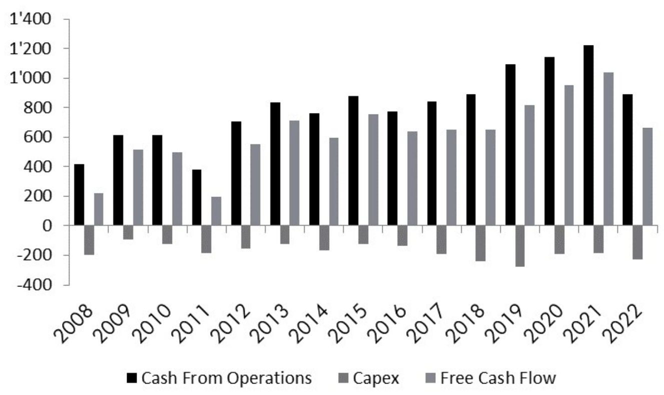
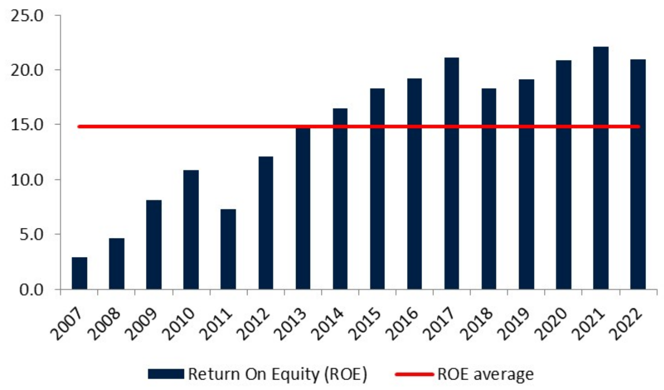


Fig.8 : Givaudan's return on equity (ROE) over time

Source: Company data, IAM research



or distribute cash to shareholders (dividends and share buybacks).

The chart in figure 7 shows Givaudan's Cash From Operations, its Capex, and the resulting Free Cash Flow. 2022 marked a lower operating cash flow as inventories rose, increasing the company's net working as a percentage of sales to 26.8%, compared to 24.0% in 2021. At the same time, total net investments in property, plant and equipment were CHF 211 million, compared to CHF 177 million in 2021, due in part to the end of the COVID-19 restrictions around the world.

Givaudan also likes to look at free cash flow as a percentage of sales. In 2022 this metric was 6.7% compared to 12.6% in 2021. Management guided to an average free cash flow to sales ratio of over 12% for the period 2021-2025.

Return on Equity

The chart in figure 8 shows Givaudan's return on equity (ROE) over the last 15 years. The average is 14.8%. We can see that the company has been increasingly focused on raising its ROE over time. The last major drops are the result of large acquisitions with lower margins that can impact the ROE in the short term.

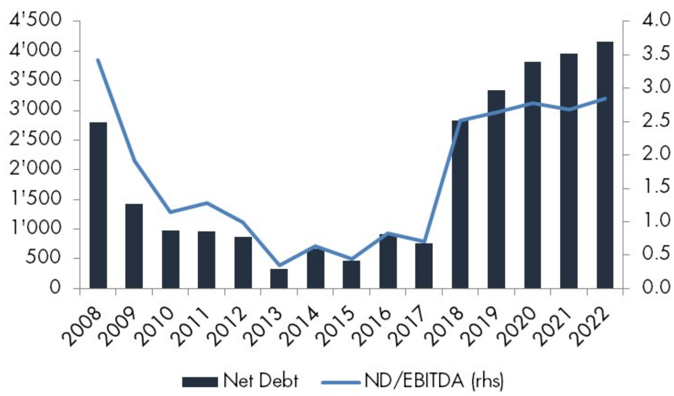
For a company to add economic value, its ROE should be above its cost of equity. The cost of equity can be calculated with the risk-free rate, the market return, and the beta. Which beta to use can be subjective, so this is not a science. With current risk-free rates close to 1.5%, we can calculate the cost of equity as 1.5% plus the beta times the market return minus 1.5%. Using an adjusted beta of 1.1 and historic market return of 8%, we find a cost of equity of 8.65%. This means that Givaudan is adding economic value with its average ROE of 14.8%.

Balance Sheet

The chart in figure 9 shows Givaudan's Net Debt, as well as their Net Debt to EBITDA ratio. We can see that management was focused on a low indebtedness, which didn't make much sense in a low interest rate environment. In 2018, the debt exploded due to the big acquisition of Naturex (1700 employees, about 10% of Givaudan's total employees). Net debt to EBITDA has moved to over 2.5x, which can be considered as in the higher range. But since Givaudan is not as cyclical as the average company, this temporary situation is acceptable. Nevertheless, as interest rates are rising again, we will carefully monitor the situation. This high indebtedness certainly

Fig.9 : Givaudan's net debt and ND/EBITDA

Source: Company data, IAM research



prevents the company from making another major acquisition in the short term.

Investment case

The defensive characteristics of Givaudan make it an attractive long-term holding. The company not only has non-cyclical end-products, but it has also strategically diversified itself between large and small customers, as well as by geography. Being close to end customers is very important, as the local and regional clients have grown about twice as fast as big multinationals. Thanks to this high diversification, Givaudan is able to mitigate specific regional downturns or out of favor brands. Another important aspect is that Givaudan also supplies manufacturers of private-label products. So, if consumers decide to down trade due to an economic recession, Givaudan can still profit from it.

We appreciate the long-term tenure of the current CEO, Gilles Andrier, which has been CEO since March 2005 (although he started working at Givaudan in August 1993 already). This is in line with the long-term investing strategy dear to IAM and proves the long-term vision of the company. We are not concerned about the next quarter if the strategy makes sense long-term (and Givaudan doesn't report on a quarterly basis anyhow).

We also appreciate that management is incentivized with financial metrics that align with shareholder's interests. For example, Givaudan has an annual incentive plan in place that equates to 100 percent of the CEO's base salary (but all other employees' incentive plans equate to less than 100 percent of their base salary). Givaudan measures financial targets and does not hesitate to cut variable compensation in case of achievements below target. For example, in 2022, the sales growth was above target, but EBITDA was below target, resulting in a variable compensation target of 90%.

On top of this annual incentive plan, Givaudan also offers a performance share plan, in which executives and selected management members are eligible to participate. The annual grant value is capped at approximately two times annual base salary, and performance shares vest three years from the grant date. Here again, Givaudan has a long-term view in place. Performance is measured on the vesting date based on the last four year's results. 80% of the incentives are financial based (relative sales to peer groups and free cash flow), while 10% is people related (senior leader's diversity/employee safety), and 10% is environment related (net greenhouse gas emissions reduction). Givaudan's relative sales growth is measured to two peer groups consisting of competitors and clients. The free cash flow target is inline with company's guidance (i.e.: 12% of sales). The senior leader's diversity target is 50% by 2030. Currently at 28%, the shorter-term target is 34% for 2023.

Valuation

The chart in figure 10 depicts Givaudan's price to earnings (P/E) multiple over the past decade and its average (23.8x).

If there is one clear negative concerning the stock, this is it. Givaudan's shares had reached lofty valuations during the post COVID bull run. The reason for reaching 45x P/E was driven by falling interest rates and investors love with quality compounders. We already exposed Givaudan's defensiveness and we do not argue with the quality compounding story. But obviously at the end of the day, valuation does matter .

Following rising inflation has somewhat impacted Givaudan, but this should only be temporary, as the company passes on higher input costs with a lag to their customers. Valuation could be supported from here, but only If interest rates have peaked. We believe this is somewhat

Fig.10: Givaudan's historic 12M forward P/E over last decade
Source: IAM research

premature and would expect the stock to at least return to its average valuation.

Risks

On March 7th 2023, Givaudan announced that is was part of an industry-wide investigation by European and Swiss authorities concerning a potential cartel in the supply of fragrances and fragrance ingredients. Givaudan said the fragrances are used in consumer products such as household and personal care products. The EU competition enforcer said it had been in contact with the U.S. Department of Justice and competition agencies in Britain and Switzerland and that the raids were conducted in consultation with them. Companies face fines as much as 10% of their global turnover for violating EU antitrust rules.

We were surprised by this announcement, as Givaudan has high ethical standards in place and puts a lot of emphasis on ESG. We believe the resolution of this investigation will unfortunately take several years, which will act as a sword of Damocles on the stock price.

Major shareholders

Givaudan has only one share class (registered shares), where one share equals one vote. As of December 31, 2022, the following beneficial shareholders hold more than 3% of the share capital:

- William H. Gates III and Melinda French Gates: 13.86%
- BlackRock: 5.06%
- Haldor Foundation: 3.01%

Interestingly, the Haldor Foundation is a foundation based in Liechtenstein, controlled by the owners of the packaging company Tetra Laval (Kirsten, Finn and Jorn Rausing, three siblings). This foundation controls Winder Investment, the asset management division of the foundation, which holds almost 10% of IFF, a direct competitor of Givaudan based in the United States.

It seems like these major shareholders have a long-term investment horizon and don't have an active influence on management's decisions.

SWOT analysis

Strengths

- High barriers to entry
- Products related to defensive qualities
- Shareholder friendly
- Market leader in attractive flavors and fragrances industry
- Strong market position in emerging markets

Weaknesses

- Relatively high capital intensity
- Lag in passing on higher raw material prices to customers
- Market power of customers

Opportunities

- Acquisition of small, innovative competitors
- Rising purchasing power in emerging economies
- Global trend towards industrially processed foods
- Health & wellness trends (non-dairy, non meat diets)
- Food services gaining in importance

Threats

- Sharp rise in raw material prices
- Economic slump in fine fragrances
- Potential product scandals such as cartel investigation
- Constantly changing regulations for chemical products
- Further interest rate hikes could put pressure on high valuation