

SGS

Market profile

Country	Switzerland
Sector	Professional Services
Market cap (CHF million)	14'072
52-week high / low (CHF)	94.4/ 71.7
Price per share (CHF)	75

Key metrics (CHF)

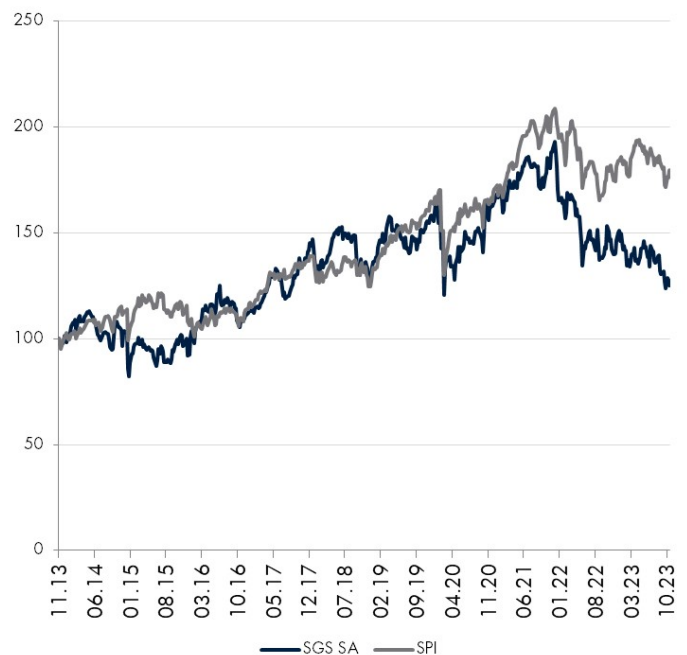
	2022	2023e	2024e
EPS	3.69	3.71	3.96
PE	20.32	20.24	18.99
P/Book	48.44	20.07	17.76
Dividend yield	3.78%	4.26%	4.26%

Executive summary

The company was founded in 1878 in Rouen, France, by Henri Goldstuck who, having seen the opportunities at France's largest ports, began to inspect grain shipments. In 1915, the headquarter was moved to Geneva, Switzerland, where it is still today. SGS now operates across a wide variety of industry sectors with more than 98'000 employees across 2'650 offices and laboratories and is active in nearly every country in the world. SGS' services can be divided into three categories: Testing, Inspection, and Certification.

SGS is organized around five divisions corresponding to five interconnected megatrends that are driving regulation and outsourcing: Connectivity & Products, Health & Nutrition, Industries & Environment, Natural Resources, and Knowledge.

Evolution of stock price with respect to benchmark (rebased)
Source: IAM



Investment case

SGS is the market leader in the structurally attractive TIC sector. Market studies estimate its annual growth potential will be of 5–7% in the coming years. In addition to structural growth, the sector offers good profitability, high returns, low capital expenditure and strong free cash flow. The TIC potential market is approximately of CHF 250 billion, less than half of which has been outsourced. Further outsourcing as well as the consolidation opportunities provide enormous growth potential as the four largest companies have a combined market share of only 21%. The most important growth drivers are the global trend towards more and more regulation and rules, privatization, outsourcing, shorter product cycles and more ESG. SGS is a shareholder-friendly company with an attractive distribution policy and intends to at least maintain its dividend per share in absolute terms.

Company description and history

The company was founded in 1878 in Rouen, France, by Henri Goldstuck who, having seen the opportunities at France’s largest ports, began to inspect grain shipments. In 1915, the headquarter was moved to Geneva, Switzerland, where it is still today. SGS now operates across a wide variety of industry sectors with more than 98’000 employees across 2’650 offices and laboratories and is active in nearly every country in the world. SGS’ services can be divided into three categories: Testing, Inspection, and Certification.

Testing: the goal of testing is to make sure that services and products correspond to the quality, safety, and performance they are supposed to. SGS tests them against relevant health, safety and regulatory standards.

Fig.1: Sales by regions, 2022

Source: SGS

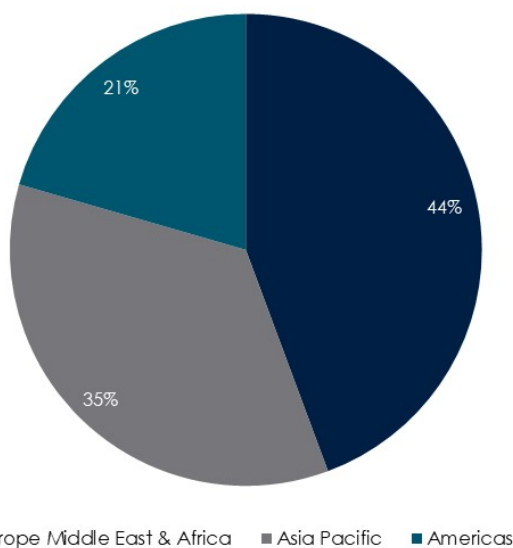
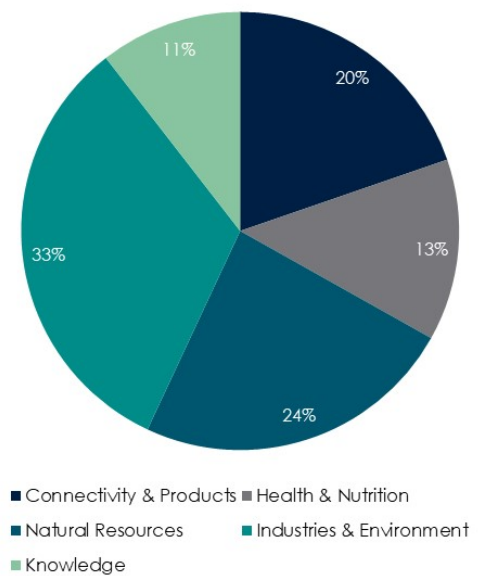


Fig.2: Sales by segments, 2022

Source: SGS



Inspection: consists in the control of quantity and quality to ensure a product meets all relevant regulatory requirements across different regions and markets.

Certification: mitigates risks, improve efficiency and compliance, and ensure best practices with audits. The ISO family is amongst the most popular standards.

Group Structure

SGS is organized around five divisions corresponding to five interconnected megatrends that are driving regulation and outsourcing.: Connectivity & Products, Health & Nutrition, Industries & Environment, Natural Resources, and Knowledge.

Megatrends enabling SGS' growth

Five megatrends account for structural growth drivers in SGS' core markets: Connectivity, Nutrition, Health & Wellness, Sustainability & Climate, Infrastructure, Consumer Empowerment.

Connectivity: with access to the internet rising rapidly and technologies such as 5G, the IoT and AI, we are entering a new era where networks of machines are digitally connected often without human involvement. A more connected world brings both opportunities and challenges for brands, manufacturers, retailers, and governments. SGS helps them to deliver safe, accessible, high-quality products and services in stores and online, ensure secure connectivity and reduce risks.

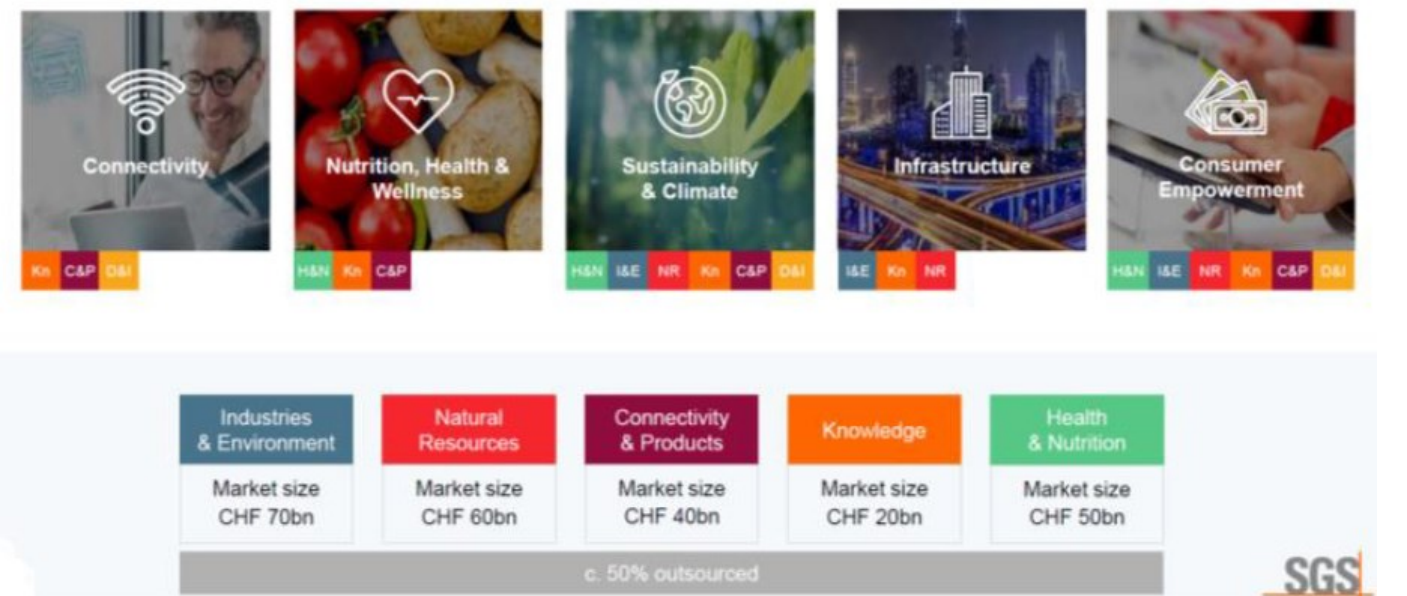
Nutrition, Health & Wellness: the nutrition, health and wellness industries are converging, responding to consumer demands for healthier lifestyles and well-being. A rise in both consumer interest and purchasing power presents tremendous opportunities for companies, but consumers need to know that the food they eat and the products they use are safe. SGS can help companies demonstrate the safety, security, quality, sustainability, authenticity and efficacy of food, healthcare, and wellness products.

Sustainability & Climate: today, many are vulnerable to climate change impacts such as droughts, floods, heat waves, extreme weather events and a rise in sea levels. The earth's finite natural resources are disappearing fast, and of all the minerals, fossil fuels, metals and biomass used each year, just 8.6% are cycled back into the circular economy. Organizations face growing scrutiny in this area, but SGS can help them put sustainability at the center of their value proposition and business models.

Infrastructure: while the growing trend towards urbanization enables increased productivity, the additional need for resources and space affects the economy, environment, and quality of life. Innovations in areas such as smart cities and smart mobility contribute to economic growth, but we can also help organizations adopt more sustainable approaches to infrastructure, transportation and community services, while protecting workers, reducing environmental footprints, managing risk, and enhancing efficiency and brand reputation.

Consumer Empowerment: more and more, consumers are flexing their purchasing power to encourage companies to take a stand on issues like sustainability, transparency, and fair employment practices. This has increased the demand for traceability and transparency across the supply chains, as people are looking to eat less meat, source more organic food, fly less and buy electric cars. SGS

Fig.3 Strategic megatrends in the TIC sector, market size by segments
Source: SGS



can help organizations keep up to date with complex regulatory obligations to reduce their legal, financial, and reputational risks.

SGS' business model

The five interconnected megatrends are driving regulation and outsourcing. SGS has positioned itself to meet these primary drivers of demand. By addressing some of the planet and society's largest challenges, SGS is generating value from structurally growing markets.

The activities that underpin SGS' business model also underpin the global economy. For example, consumers can be confident the products they buy have been **tested** and meet the required quality and safety standards and regulations. A proliferation of global brands has increased the need for brand protection, leading to greater scrutiny of supply chains and quality, health and safety and environmental systems. Importers know the content of their cargo has been **inspected** and meets quality standards. The content has been monitored across supply chains and is the same as specified in their contract. In an increasingly digital world, ever more sophisticated products need a high degree of testing expertise. ICT devices and systems need to be certified against international security standards to provide the highest levels of assurance and confidence. **Testing** reduces risks, shortens time to market and test the quality, safety, and performance of products against relevant health, safety and regulatory standards. Inspection controls quantity and quality, and helps customers meet all relevant regulatory requirements across different regions and markets. **Certification** ensures products, processes, systems or services meet national and international standards and regulations.

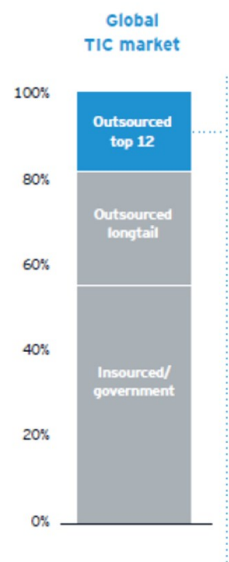
Corporate strategy

SGS is driving its business forward with clear objectives for market leadership, digital innovation, and sustainability solutions.

SGS's divisions are closely aligned to the key TIC megatrends and customer demand. The combined size of the TIC market is estimated to be worth around CHF 255 billion on a global basis, though only 45% may be ac-

cessible, i.e., outsourced to a third-party business like SGS.

Fig 4: Breakdown of the global TIC market
Source: Ernst & Young



The company's strategy is based on three pillars:

- 1) Invest to consolidate leadership positions.
- 2) Become the most digital company in the TIC industry.
- 3) Increase proportion of revenue from sustainability solutions.

1) SGS is a global leader in three of its divisions: Knowledge, Natural Resources, and Connectivity & Products. The company aims to build on these leadership positions through expanding its technical consulting network, particularly in Europe and Asia, developing new digital solutions. SGS is optimizing its field and lab resources to generate network synergies, building on its cybersecurity expertise, and addressing the key opportunities in the environmental, connectivity, mobility, and natural resources industries. SGS is also accelerating investment in biopharma and analytical services to grow its Health & Nutrition division. The Environment, Health & Safety services will become an important building block in the Industries & Environment division through the integration of SGS Analytics.



2) SGS' vision is to become the most digital company in the TIC industry through a customer-centric approach. The company has made further progress towards its aim of linking at least 20% of its revenues to digital services by 2023, with more than 50% of applicable inspections and audits being done remotely. SGS is enhancing existing services to deliver them faster and better. Technologies, such as AI are helping SGS create new services and the company continually assess emerging technology trends to explore the potential for entirely new markets. In 2022, SGS implemented a Digital Builders Organization that aims to design and develop technology-based products to support the company's services with a short time to market and a real impact on business operations. SGS already has three products in testing phases with more coming in the following years. SGS is digitally transforming its labs to simplify the way they work and the service they provide. Beyond 2025, SGS will become a fully data driven company, connecting real-time data with people and processes to build digital services that improve the employee and customer journey.

3) A large majority of companies are just followers with a less mature approach to sustainability. They take a compliance and risk approach to address regulatory environmental, social and governance risks through ISO and standards. SGS expects these companies to move

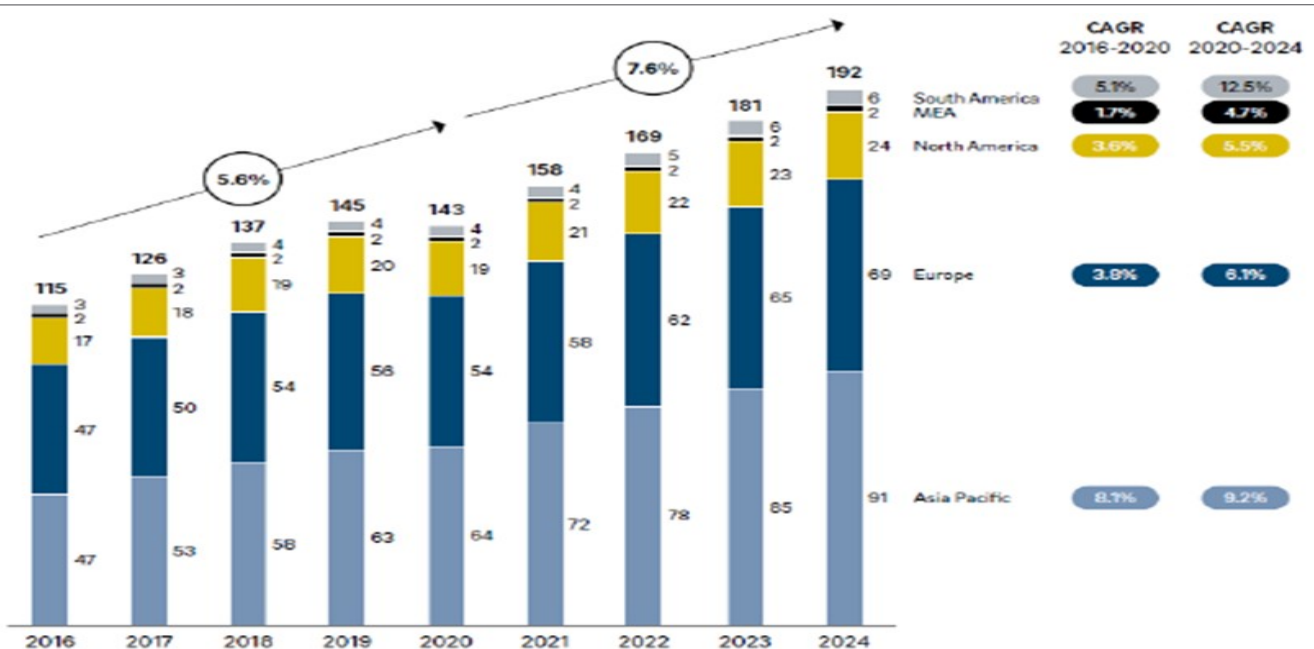
towards a holistic approach to sustainability that encompasses their entire supply chain. From sourcing raw materials to using the final product. SGS is helping companies to implement better and more efficient processes, address stakeholder concerns and reduce risks. SGS can now offer sustainability solutions across all its divisions. In 2023, SGS should generate over 50% of its revenue from its Sustainability Solution Framework.

Peer comparison and total addressable market

As mentioned earlier, the total TIC market is about CHF 255 billion, of which approximately 45% or CHF 115 billion has been outsourced. If this estimation is correct, SGS' market share would be of less than 6%, and the combined market share of SGS, Bureau Veritas, Intertek, and Eurofins would only reach 21%. Therefore, considerable additional outsourcing potential certainly exists, and more than 50% of the business continues to be conducted by companies in-house or by governments.

When looking at the competitors of SGS, the British group Intertek and the French company Bureau Veritas are usually the main candidates. However, thanks to its strong growth over the recent years, the French company Eurofins can now also be counted as a peer in terms of size. In terms of portfolio, SGS is most comparable to Intertek, as both have a strong market position in the con-

Fig.5: Growth trend in the TIC sector by regions
Source: Roland Berger



sumer business, called Connectivity & Products at SGS, and a comparable competitive situation with regard to commodities (though Intertek is more focused on oil). Bureau Veritas also compares well with SGS, but with a stronger focus on the construction business, while Eurofins has a different approach with a strong focus on Europe, health, food, and the environment. When it comes to the healthcare segment in the TIC sector, Eurofins is without doubt the first choice.

What was sometimes underestimated in the past with the strong focus on the big players is that the TIC sector is competitive, and not only features numerous providers, but new players are also constantly emerging. This is a consequence of the attractiveness of the sector, with arguments such as structural growth, high profitability, strong cash flow, limited investments and substantial returns. Logically, the sector is therefore always a stumping ground for private equity firms. At the same time, the barriers to entry should not be underestimated: significant know how, well-trained staff, a network of laboratories etc. But they are not insurmountable either. Although capital is needed, it is not necessary to build entire factories, for example. Overall, the barriers are average. They are higher if one wants to build a global player with a comprehensive offering, but lower if one wants

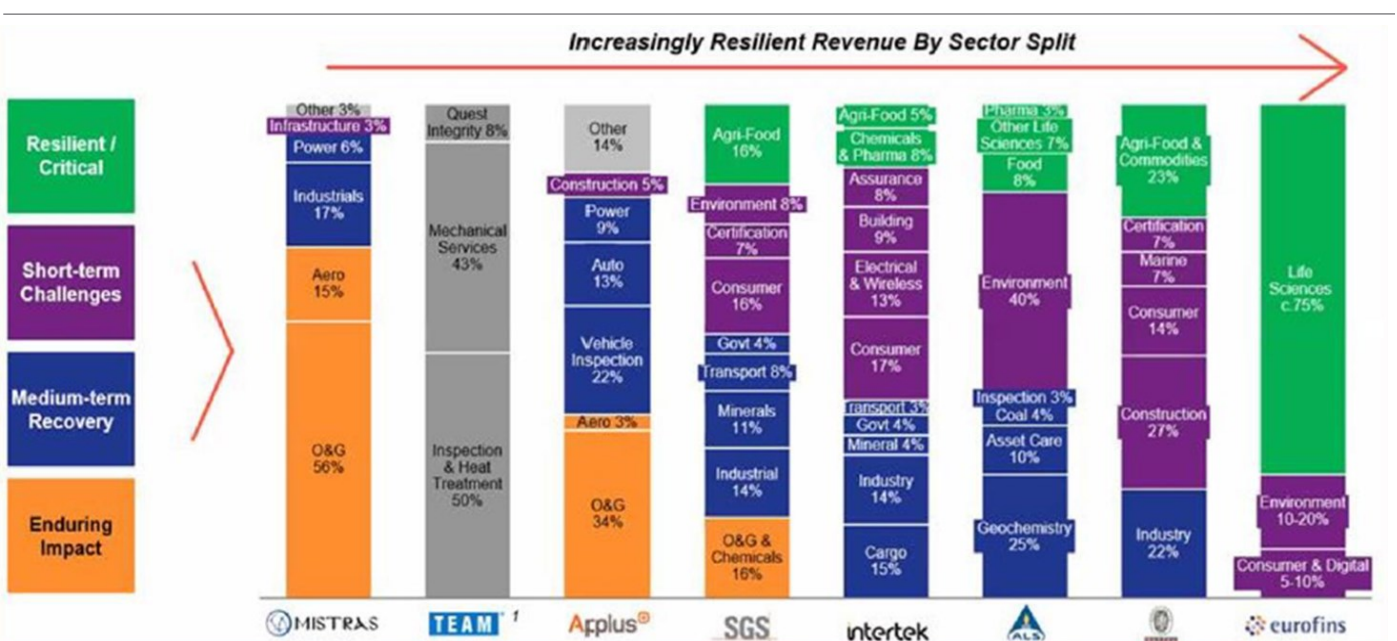
only an individual offering in individual markets.

In addition to the large global players, there are several providers that are of considerable size and offer a wide range of services, but are not listed on the stock exchange, such as Dekra, DNV or TÜV. In addition, around the world, many of TIC tasks are handled directly by national governments, without the pressure of the capital market and with completely different demands on profitability.

ESG overview

Regarding carbon emissions, SGS benefits from the fact that the group is not a manufacturing company, but a service company without its own factories. SGS has already ensured a neutral carbon footprint since 2014 through offsetting measures and has committed to increasing the share of revenue of its sustainability solutions to over 50% (47.3% in 2022) by 2023. The Board of Directors is diverse. The percentage of women is 33% (three out of nine), and nine different nationalities are represented. The proportion of women on the Management Board and Operation Council, which consists of a total of 17 people, is 6% (one woman). The key performance indicators used to calculate variable remuneration are clearly defined and role-specific, with the target

Fig.6: Positioning of the main TIC players as defined by Eurofins (2021)
Source: Eurofins



achievement of the respective key figures being shown in a very transparent and comprehensible manner.

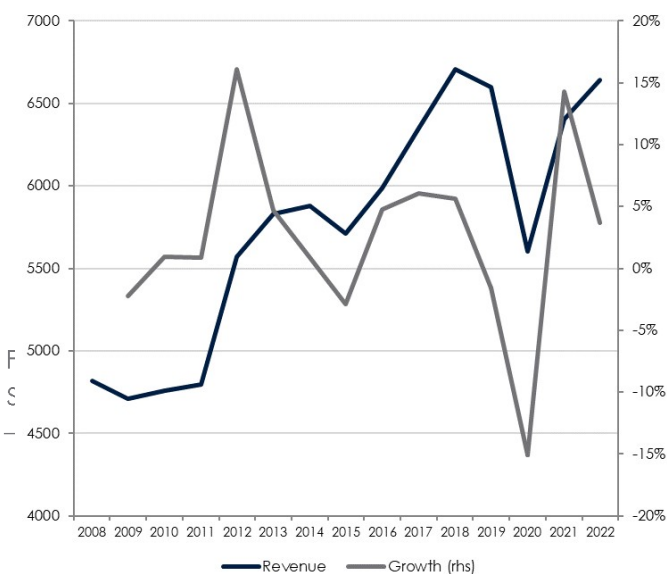
Financial analysis

Revenues

Net sales grew 3.7% in Swiss franc in 2022, this may seem a bit disappointing, but organic growth was 5.8%. Anyway, in part due to divestments, the level of sale in 2022 was still below the level reached in 2018. As SGS business is largely dependent on global trade, covid-related lockdowns, especially in China, have negatively affected the company. Now things are normalizing, but the relative weakness of exports growth in China is still a matter of concern.

Fig.7: Evolution of revenue

Source: SGS

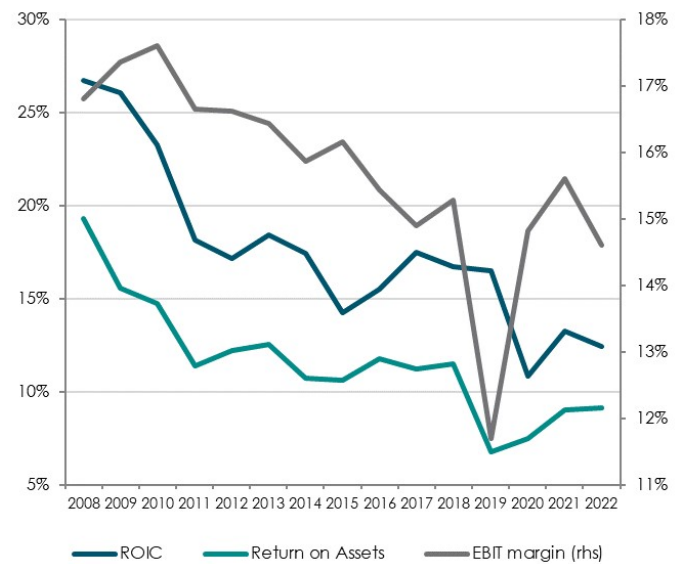


Profitability

SGS has not seen any significant margin increases in recent years. The trend towards higher personnel costs, which could not be fully compensated by price increases, tended to lead to a decline in margins in 2022. However, SGS has an arsenal of measures to increase profitability or counteract margin pressure. The most important are restructuring programs, digitalization of the laboratories, and change in the portfolio towards higher-margin products and regions.

Fig. 8: Evolution of ROIC, Return on Assets and EBIT margin

Source: SGS

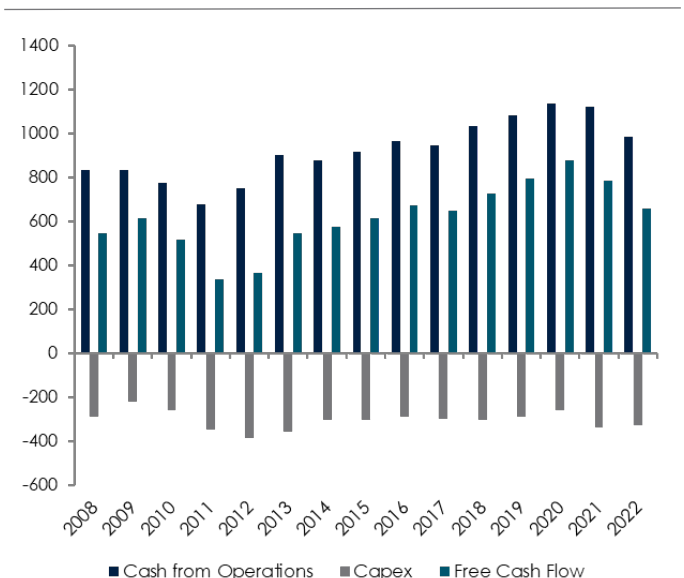


Capex and cash flow

SGS operates a business that generates substantial cash flows. The digitalization of laboratories will require capex, but capex level is well under control. M&A activities may require additional capex but SGS' appetite for acquisition is currently less pronounced than it has been in the past. As a result, the company is likely to generate a robust free cash flow in the foreseeable future.

Fig. 9: Evolution of Free Cash Flow

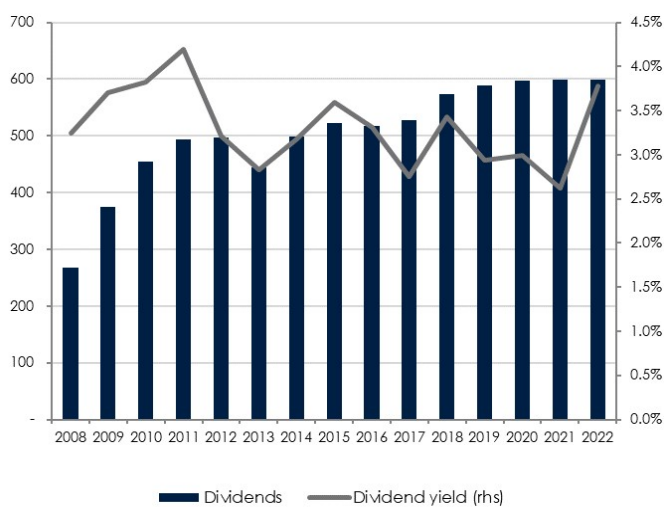
Source: SGS



Capital distribution

SGS is generally a very shareholder-friendly company with an impressively high payout ratio and, if possible, also share buybacks. The dividend is currently fixed at CHF 3.2 per share, which corresponds to a yield of more than 4%. The dividend will probably not be increased until the payout ratio is back at 75%

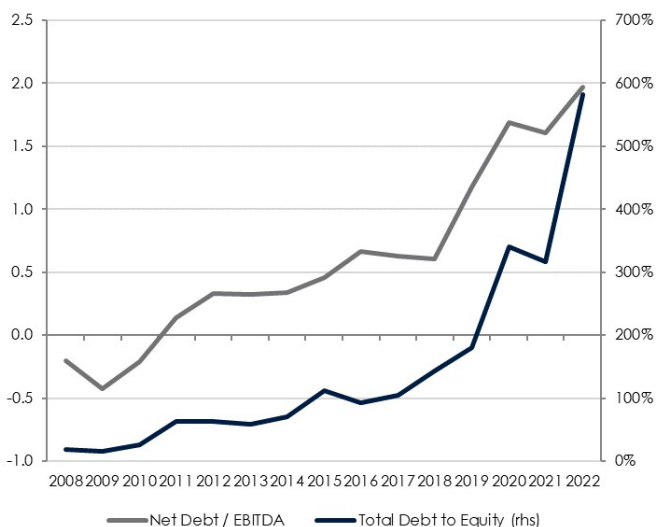
Fig.10: Capital distribution
Source: SGS



Adequate balance sheet

At the end of 2022, the ratio of net debt to EBITDA was 1.97X. This is not a problem for a company like SGS with strong cash flow generation, and this could even go

Fig.11: A relatively low equity base
Source: SGS



to 3.0X if SGS was to find an attractive acquisition target. This would correspond to additional debt capacity of about CHF 1.5 billion. However, the debt-to-equity ratio is elevated at nearly 600%.

Investment case

SGS is the market leader in the structurally attractive TIC sector. Market studies estimate its annual growth potential will be of 5–7% in the coming years. In addition to structural growth, the sector offers good profitability, high returns, low capital expenditure and strong free cash flow. The TIC potential market is approximately of CHF 250 billion, less than half of which has been outsourced. Further outsourcing as well as the consolidation opportunities provide enormous growth potential as the four largest companies have a combined market share of only 21%. The most important growth drivers are the global trend towards more and more regulation and rules, privatization, outsourcing, shorter product cycles and more ESG. Cost inflation, especially in personnel, but also in energy, has led to a margin compression over the last few years. However, the worst is now over and SGS has started to implement a rationalization program and to optimize its portfolio. As a semi cyclical company, SGS is unlikely to come through a potential recession unscathed, but its defensive qualities are considerable. For example, over 50% of its tests are required by law, and SGS has a portfolio of contracts that usually have multi-year durations. The company is shareholder-friendly with an attractive distribution policy and intends to at least maintain the dividend per share in absolute terms until the payout ratio goes back to 75% (at 92% in 2022).

Main risks

- Global economic slowdown
- Conflict with China and/or trade disputes
- Emergence of new competitors
- Difficulties to improve margins