

March 2023

# Sika

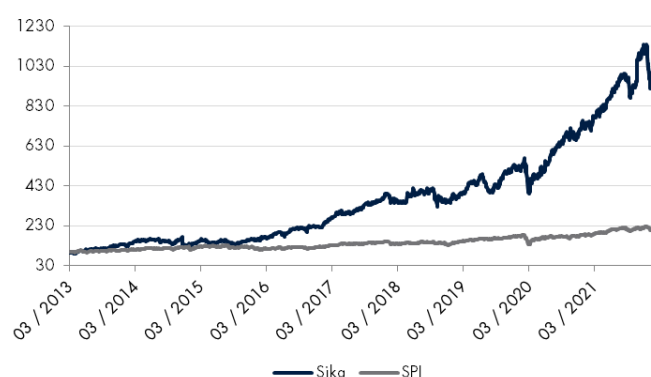
## Market profile

Country	Switzerland
Sector	Industrial
Market cap (CHF bn)	38.1
52-week high / low (CHF)	318.90 / 190.10

## Key metrics (CHF)

	2022	2023e	2024e
EPS	7.29	8.13	9.70
PE	30.4x	31.3x	26.2x
Dividend Yield	1.3%	1.3%	1.6%

Evolution of stock price with respect to benchmark (rebased)



## Executive summary

Sika's business involves specialty chemicals that are used in the construction, building, and manufacturing industries. The full range of Sika's core competencies are used in sealing, bonding, damping, reinforcing, and protecting. The company provides innovative solutions that add significant value, plus comprehensive services, expertise, training, and custom-designed solutions.

Sika has subsidiaries in 101 countries around the world and manufactures in over 300 factories. With more than 27,500 employees, the company generated annual sales of CHF 10.49 billion in 2022.

The majority of revenues come from the construction business, with an emphasis on renovation works. The industrial business is focused on the automobile market.

Sika is also a clear leader in decarbonation solutions, helping the environment. Sika's clients purchase their products to reduce the CO<sub>2</sub> content of their own products, especially in the cement and concrete industry, which represents about 8% of the planetwarming carbon dioxide emissions.

The company stands out as a high return, high growth company within the building materials space. Its products are positioned as critical ingredients to meet climate neutrality goals in construction and automotive, have significant patent-backing, yet represent only a small proportion of total building/car costs (<1% according to Sika).

The group has grown to a critical size where adding products will be highly beneficial due to its large distribution network. This makes any future acquisitions interesting as Sika will be able to leverage its distribution network and gain from synergies.

## Company description

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## History of the company

Sika was founded in 1910 by Kaspar Winkler. He invented Sika-1, a quick-setting waterproofing admixture for mortar, which was used to waterproof the Gotthard Tunnel. Kaspar Winkler recognized an upcoming global need for his groundbreaking admixtures and launched subsidiaries around the world. Already in the 1930s, 15 Sika subsidiaries in Europe, USA, Argentina, Brazil and Japan established new construction chemicals markets.

After having experienced the boom and bust of the cyclical construction market, Sika decided to diversify its businesses. In the 1980s, Sika developed the versatile adhe-

sive Sikaflex which opened a new field of business in the automotive industry.

Another important product group that was able to withstand the recession was "renovation and maintenance". In order to reduce dependence on the construction industry in the future, the product range of "Renovation and Maintenance" was specifically expanded. A market field that is still being pursued today.

The 1990s was Sika's decade of most rapid growth. Between 1990 and 1995 alone, 16 new subsidiaries were founded. Turnover increased from CHF 2 billion to more than CHF 4.6 billion, a significant portion of which was contributed by the 36 companies acquired between 2000 and 2008. During that same period, the workforce increased from 8,000 to 13,000.

Since 2000, Sika summarizes its core competencies in bonding, sealing, damping, reinforcing and protecting. From basement to roof, Sika intended to become the market leader in these technological disciplines.

A major recognition of the importance of the company was the inclusion of Sika in the Swiss Market Index (SMI) in May 2017. This represents a milestone in the history of Sika and a great achievement that was only possible

Fig.1: The Sika logo, the yellow background evokes construction sites, where Sika's products are used

Source: Company data, IAM research



due to the successful growth strategy and focused performance management.

In May 2018, Sika, the Burkard family and Saint-Gobain have signed agreements which terminated and resolved their dispute to the common benefit of all parties involved and that of their respective shareholders and stakeholders. Corporate governance was much enhanced with the elimination of the dual share class structure. All shares are now registered shares and each share represents one vote at the general meeting. This structural change was the catalyst needed for Sika to make larger acquisitions to consolidate the industry.

In May 2019, Sika completed the acquisition of Parex, the biggest acquisition of the company's history at that time. With this acquisition, Sika further strengthens its world leader position in construction chemicals.

In November 2021, Sika announced it had agreed to acquire MBCC, the former BASF construction chemicals business, for a consideration of CHF 5.5 billion; its biggest acquisition in history. Originally, Sika thought that it could get regulatory clearance by end of 2022, but as of the date of this report, the acquisition has not yet been approved. Sika will have to sell some acquired business in areas where its market position would have been too dominant.

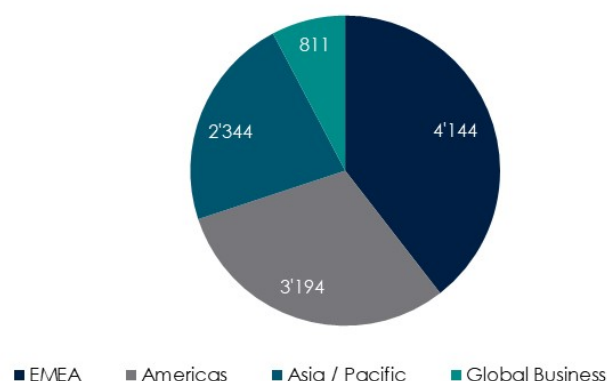
## Geographic exposure

Sika has two business lines: construction and manufacturing. Because manufacturing is dedicated to automobile construction, the company doesn't know where their end products are being implemented. Automobile clients purchase a fixed amount of products and use them worldwide. Maybe Sika could ask their industrial clients for more granularity, but for now, Sika simply reports these sales under "Global Business".

The company provides sales by geographic regions for the construction industry, where sales are very local. The biggest region is Europe, Middle-East, and Africa (EMEA) as we can see in figure 2. Unfortunately, this is also the slowest growing region. The Americas region is mainly the USA, where Sika is benefiting from a huge infrastructure investment business. The fastest growing

Fig.2: Revenues by region

Source: Company data, IAM research



region is the Asia/Pacific region which consists mostly of emerging markets.

## Industry Overview & Competitive positioning

Over the past few decades, Sika has steadily extended its global market penetration. Thanks to the high added value that Sika products offer customers, this trend is set to accelerate further. Sika estimated the total market in which it operates to be approximately CHF 80–100 billion. If we take the higher end of that range, Sika has approximately a 10% market share. This will of course increase with the integration of MBCC, but remains nevertheless relatively low.

Demographic change has resulted in a lack of skilled labor, and the construction industry has been particularly affected by this development. Added to this, construction has seen only very modest efficiency gains over recent decades compared to other industries. Thanks to automation and digitalization, productivity gains have recently materialized. However, Sika has proven to be an exception to this rule. The company has long held an outstanding reputation for providing products and solutions that offer superior performance. What's more, it has invested heavily in the sustainability of its products in recent years. As a result, Sika can increasingly offer its customers solutions that deliver not just improved performance such as greater strength and higher temperature resistance, but also greater sustainability such as a smaller carbon footprint or improved air quality. In addition, Sika products offer benefits in application by reducing the

number of work stages, or because they cure faster or can be reliably applied by less qualified staff.

Demand for construction chemical products in the construction industry is growing and market penetration is rising. From 1991–2020, construction chemicals roughly doubled their share of global construction output, and the above-average growth trend will likely continue. As a leading global company in construction chemicals with a comprehensive portfolio of innovative technologies, Sika will enjoy an above-average benefit from this development.

Sika has established deep roots in its local markets, which help the company tap into new customer groups and intensify cross-selling. Solutions adapted to specific needs can be applied to large-scale construction projects. Construction companies, tradespeople, and private consumers have straightforward access to a broad spectrum of the company's products and solutions through e-commerce channels or local stores.

Over the next few decades, market penetration is likely to accelerate for construction chemical products. Sika estimates that productivity increases on building sites alone will see market penetration increase by a factor of 2.5 by 2050. If regulators increasingly embrace the net zero target, Sika believes the market penetration of construction chemicals could increase by a factor of four. As part of its Green Deal, the European Commission has stipulated that CO<sub>2</sub> emissions should be brought down by at least 55% by 2030 (compared to 1990 levels). Construction chemical products and solutions will pro-

vide the construction industry with key support in achieving its targets.

The company's Strategy 2023 is aligned with the six major megatrends of our time: digitalization, emerging market growth, climate change, demographic change, urbanization, and automation. These megatrends are closely interrelated and influence one another. They are opening huge potential for Sika in terms of structural growth opportunities.

One thing is clear: construction chemicals are set to become far more important for the construction industry, and this is a strategic success factor for Sika.

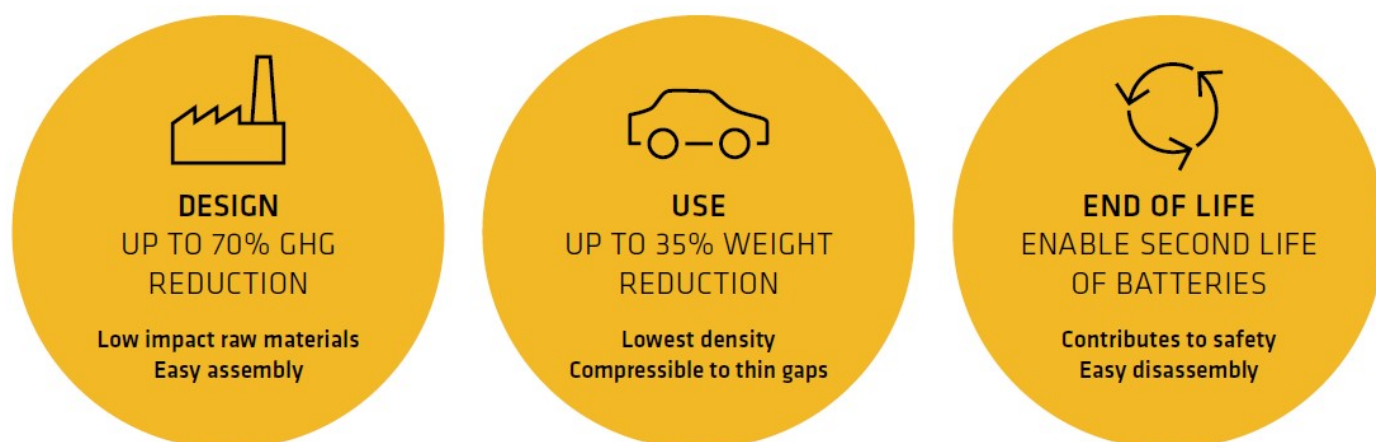
As for Sika's Global Business (automobile industry), there are high hopes that the company's products will grow spectacularly. With its range of adhesives and sealants, Sika is well-positioned to benefit from the increasing demand for electric vehicles worldwide.

Approximately 47 million electric vehicles will be built by 2030 – four times the annual production in 2022. This massive increase is being propelled by governments as transport accounts for about 20% of global CO<sub>2</sub> emissions, making it the second biggest emitter of carbon dioxide. Governments' net zero pledges and regulations are the biggest drivers of growth in this sector.

Up to now, however, the limited range of battery-powered vehicles has deterred many motorists from buying EVs. The capacity and efficiency of the battery systems are usually the critical selling point. Sika can support their customers by offering high-powered solutions

Fig.3: Sika's innovations enable more sustainable batteries

Source: Company data, IAM research





for improved heat management and make batteries stronger and safer. Products in this area include gap fillers, thermal conductive adhesives, sealing and bonding solutions and fire protection coatings. These products enable optimum and simple assembly of the battery packs and extend their service life.

At the same time, Sika provides solutions that help to give batteries a new lease of life at the end of their normal lifecycle. These facilitate disassembly of the batteries so that the cells can be used otherwise. This technology is another area in which Sika has been playing a pioneering role, generating both ecological and economic benefits for carmakers. Sika's market potential for battery management products and solutions goes far beyond passenger vehicles – extending, for example, to trucks, delivery vans, two- and three-wheeled vehicles, and construction machinery.

Sika is also using the expertise gained in e-mobility applications for systems that store renewable energy, like those for charging electric vehicles. The company believes that by 2030, energy storage systems will make up about 15% of the total market potential. As demand in most regions is extremely dynamic, Sika sees plenty of opportunities for growth.

#### Battery Solution examples:

- Sika's thermally conductive adhesive solutions provide both heat transmission and electrical insulation for the assembly of battery cells in modules or packs.
- For the assembly of battery trays, Sika offers the widest range of sealants and adhesives.
- Fireproof products are incorporated to prevent the spread of fire in the event of a fault or overheating in battery cells and arrays or in the whole pack.
- In addition, Sika offers special fire protection coatings that subdue fires and prevent them from spreading quickly.

## Financial analysis

### Growth

Growth stands at the center of the Sika strategy. Various initiatives contribute to the achievement of the targets. Since 2015 Sika made 25 acquisitions, opened 11 new

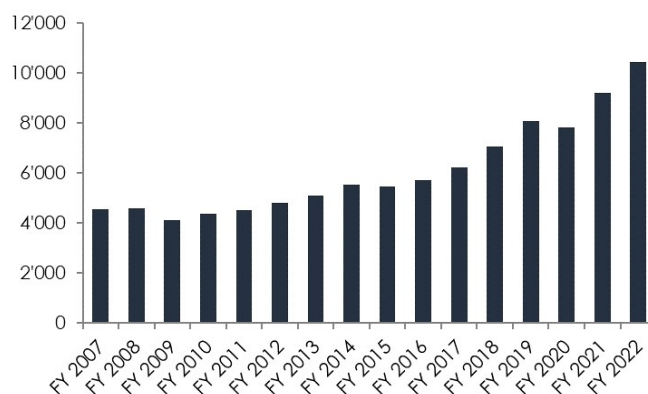
national subsidies and 44 new plants. The successful target market concept has been implemented and megatrends are driving growth. In this context, innovation is one of the pillars of the Sika growth strategy: 425 new patents were filed and 21 global technology centers are maintained throughout the world.

Growth in the Global Business is also extremely impressive. In 2022, the global automotive business grew by +22.2% in local currencies, clearly outpacing the growth in the number of new vehicles produced. For the automotive business, Sika is anticipating a recovery in the market over the medium term with continued growth stimuli from electromobility and alternative drive concepts in particular.

As we can see in figure 4, Sika's topline growth was 5.7% compounded annually over the last 15 years. But in the most recent 5 years, the compound annual growth rate was even higher, at 10.9%. This is partly due to the higher number of acquisitions included, as well as the higher focus on renovation and environmental criteria.

Fig.4: Sika's revenues over time

Source: Company data, IAM research



For 2023, Sika anticipates sales growth of 6% to 8% (excluding MBCC). According to management, about half (ie: 3 to 4%) should be accounted for by price increases. On the volume side, smaller bolt-on acquisitions should account for about 1 to 1.5% and purely organic volume growth for 2 to 2.5%. Sika also guided for above-average EBIT growth (ie: a margin expansion), once again excluding MBCC (which has about a 4 point lower margin than the Sika group).

## Margins

As we can see in figure 5, Sika's margin have been steadily increasing over the last 10 years. In 2019, the margin dipped significantly, which was mostly due to Sika's largest acquisition at the time (Parex) which had lower margins than the overall group.

Fig.5: Sika's adjusted EBIT margin over time

Source: Company data, IAM research



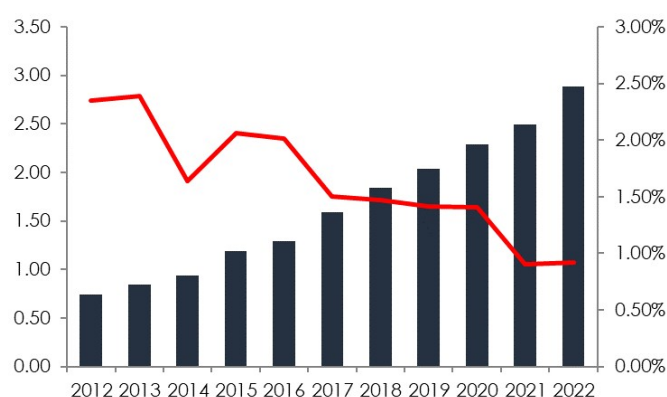
In 2019, the company also expanded its production sites to seven new countries, including Ethiopia, Indonesia, and Serbia. Greenfield investments take time to become as profitable as established countries, but this shows Sika's long-term vision and willingness to invest in emerging countries that will grow faster over time.

## Dividends

As we can see in figure 6, Sika's dividend policy is quite straightforward: pay an equal or increasing dividend each year.

Fig.6: Dividends per share in CHF and dividend yield (rhs)

Source: Company data, IAM research



But since Sika should be considered more as a growth story, we can also see that the dividend yield is quite low (about 1% currently). We prefer that the company keeps the cash to be reinvested in new businesses and/or make sensible acquisitions, as it is currently doing.

Also, 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. Unfortunately, Sika is not a proponent of share buybacks and only returns capital through dividends.

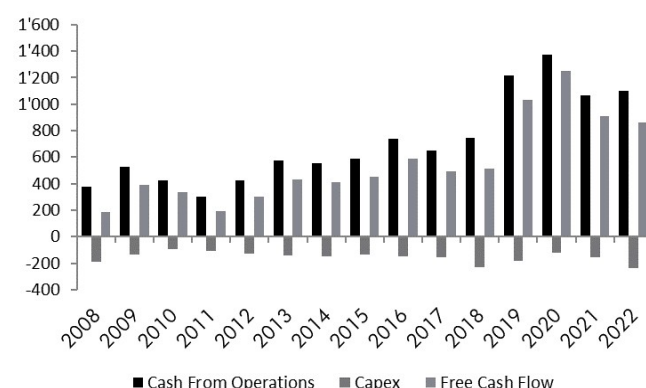
## Free Cash Flow

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

As we can see in figure 7, Sika's free cash flow has always been positive over the last 15 years. This is quite a feat, considering how cyclical the construction and industrial businesses are. This shows that Sika was able to

Fig.7: Sika's cash flow over time

Source: IAM research



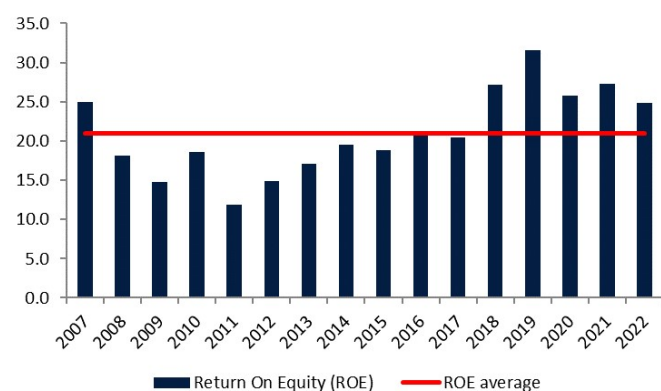
reduce the cyclicalities by focusing on less cyclical end markets such as renovations and increasing its market share of the automobile industry.

### Return on Equity

The following figure shows Sika's return on equity (ROE) over the last 15 years. The average is 21%.

Fig.8: Sika's Return On Equity (ROE)

Source: Company data, IAM research



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. Under this model, the cost of equity equals the risk-free rate of return plus the beta times (market rate of return minus the risk-free rate of return). Which beta to use can be subjective, so this is not a science.

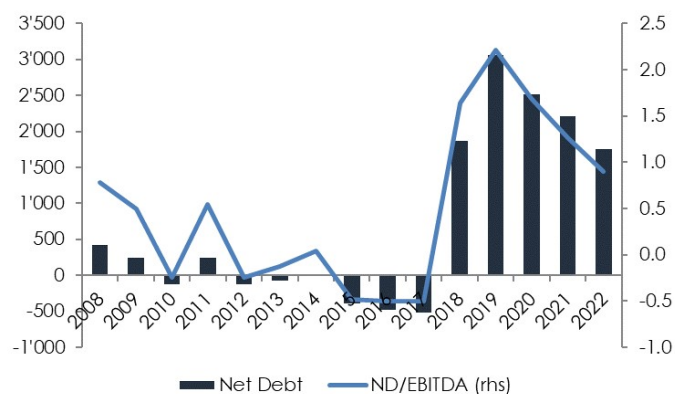
With current risk free rates at 1%, we can calculate the cost of equity as the beta times the market return minus 1%. Using an adjusted beta of 1.5 and historic market return of 8%, we find a cost of equity of 11.5%. This means that Sika is adding significant economic value with its average ROE of 21%.

### Balance Sheet

The chart in figure 9 shows Sika's Net Debt, as well as their Net Debt to EBITDA ratio. Currently, the ND/EBITDA ratio is at 0.9x, but this excludes the final cost of the acquisition of MBCC. We can see that the last big acquisition of Sika - Parex in 2019 - spiked this ratio to over 2x, which is the upper end of what we believe would still be acceptable by investors.

Fig.9: Net Debt (ND) and ND/EBITDA

Source: Company data, IAM research



Since Sika doesn't have enough cash for the CHF 5.5 billion acquisition, the company will have to raise debt and/or equity. The company has not disclosed exact details, and only said it "intends to put in place a long-term funding structure comprising a combination of cash on hand, bank loans, and capital markets instruments". Nevertheless, we have seen Sika emit for CHF 650 million of new debt in March, so we believe that the company is unlikely to emit any new shares in order to complete this acquisition.

We also note that since the announced acquisition intention in 2021, Sika was able to sell some parts of the MBCC business (due to regulatory requests), so the final cost will be less than CHF 5.5 billion.

### Investment case

Sika is well-positioned in both emerging and mature markets thanks to its global network of 101 subsidiaries, along with its first-class solutions that are tailored to customer needs. The company creates sustainable value for its stakeholders to whom the derived economic value is distributed. This includes governments through taxes, employees through compensation and benefits, shareholders through dividends and increased enterprise value, suppliers and service providers through raw material and service prices, and society through taxes and community projects. Part of the value earned is retained and invested to develop new products and solutions, acquisitions, and capital investments.

Sika stands out as a high return, high growth company within the building materials space. Its products are positioned as critical ingredients to meet climate neutrality goals in construction and automotive, have significant patent-backing, yet represent only a small proportion of total building/car costs (<1% according to the company).

Sika is also unique in the sense that it's a global one-stop shop with products across multiple categories (admixtures, waterproofing, roofing, coating and sealing). This makes the company much more attractive for large contractors, as competitors operate in some, but not all of these categories.

The group has grown to a critical size where adding products will be highly beneficial due to its large distribution network. This makes any future acquisitions interesting as Sika will be able to leverage its distribution network and gain from synergies.

## Valuation

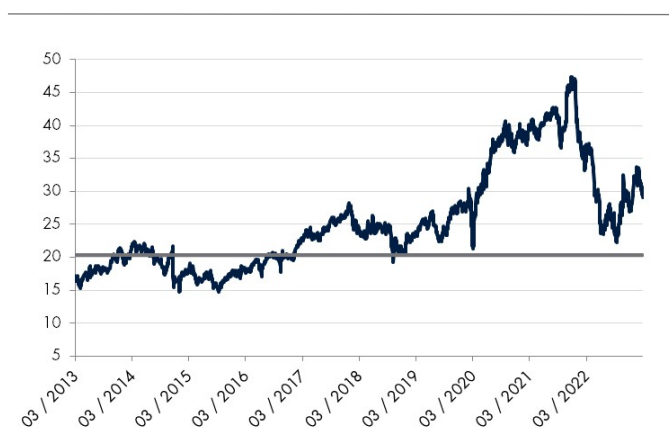
The chart in figure 10 depicts Sika's price to earnings (P/E) multiple over the past decade and its average (20.4x).

As we can see, Sika's valuation has expanded quite massively (doubling) over the last decade. This was caused by two factors: intrinsic and external ones.

Intrinsically, the company became a much better company during the last decade: moving to a one share/one vote structure, no more blocking minority, focus on ESG, focus on long-term growth markets, less cyclicality, etc.

Fig. 10: Historic P/E over last decade

Source: IAM research



The market environment also helped, as growth companies were structurally aided by falling interest rates. The era of cheap money helped Sika fund a dozen of acquisitions, making it a stock market darling. ESG funds invested massively in Sika, as it was a clear leader in the construction/industrial domain. Sika became a large capitalization and was added to the SMI, bringing even more interest to the company. The share price itself more than octupled over the last decade.

Today, with rising interest rates again, growth stocks are less a focus of investors. For this reason, we would rather wait for a better entry point before purchasing new shares.

## Risks

Integration of MBCC will take time and a lot of focus from management. As MBCC was originally owned by the German giant BASF, there are quite some cultural differences in management styles. While Sika aims to empower employees with a more entrepreneurial spirit, it seems that ex-BASF employees were not as aligned with that goal. We are less worried however on the margin front, as MBCC products are deemed reputable, so Sika should be able to increase prices on those. All in all, we think Sika management's has the capabilities to integrate MBCC, as they have shown with the last large acquisition, Parex.

More general risks include a macroeconomic downturn impacting construction and consumption. Recessions are inevitable, but are outside of management's control. Also, this is more a general short term risk than a company specific risk. We note that Sika has done a fantastic job of mitigating cyclical risks with their focus on renovation and maintenance markets.

Inflation in raw materials could also impact Sika, as more than half of operating costs are from materials expenses. Given that over 70% of material inputs are oil derivatives (like epoxy, polyurethane, PVC...), there is a high correlation between the change in material expenses and crude oil prices.