Company Follow Up

Bank Leu Swiss Equity Research

GOODS INSPECTION

08.11.2005 **SPI 7,254**

Registered shares | Price: CHF 1,020 | High/Low (12mth): CHF 1,022/744 | New price target (12mth): CHF 1,250

in CHF	EPS	FCF	Dividend	Book value	P/E	EV/ EBIT	EV/ EBITDA	EV/ Sales	FCF yield	Div yield	Price to book
2008 E	74.6	62.5	25.00	326	13.7	8.1	7.0	1.38	6.1%	2.5%	3.1
2007 E	64.4	47.1	21.00	274	15.8	9.9	8.5	1.64	4.6%	2.1%	3.7
2006 E	55.5	38.7	18.00	229	18.4	11.9	10.1	1.91	3.8%	1.8%	4.5
2005 E	46.7	25.8	15.00	190	21.8	14.7	12.1	2.21	2.5%	1.5%	5.4
2004 A	35.7	15.3	12.00	157	28.6	19.6	15.0	2.55	0.0%	0.0%	6.5

Lt growth: 12.5% WACC: 8.3%
PEG ratio 2005E: 1.7x ROIC (2005E): 26.5%

Buy

SGS

Bloomberg: SGSN VX
Reuters: SGSN.VX

www.sgs.com

Investor day

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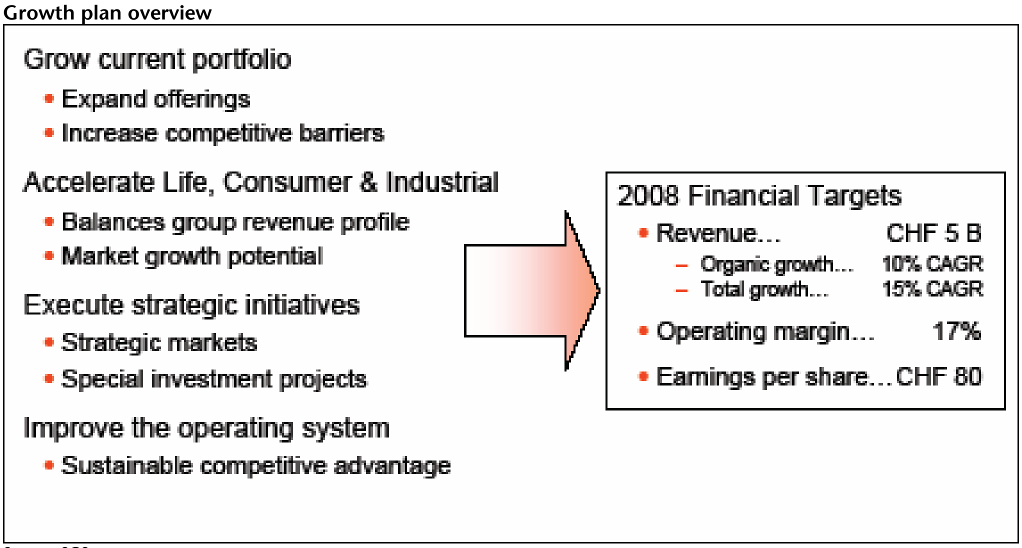
- **At yesterday's SGS presentation our bullish view on the company was confirmed. SGS is definitively no longer a restructuring story – it has become a growth company.**
- **We believe 15% to 20% EPS growth over the next three years is possible. As a result, we expect investors will change their perceptions of the company and value SGS at higher multiples.**
- **The new targets presented are no doubt aggressive, but in our view achievable. The plan is not a radical revolution, being mainly based on the existing portfolio. We stress that our confidence in the growth plan is based on several factors.**
- **Due to the increased visibility we have raised our earnings forecasts for 2008; we now expect EPS of CHF 75, slightly below the new target of CHF 80.**
- **Additionally, we raise our 12-month target price from CHF 1,100 to CHF 1,250, in line with our DCF model or 17 times projected 2008 earnings.**

INVESTMENT CONCLUSION

At yesterday's SGS presentation our bullish view on the company was confirmed. SGS is definitively no longer a restructuring story, but has become a growth company. We had expected new targets, but believe that the outcome was still a positive surprise. We were expecting targets that were less specific, for example 8% to 10% organic growth or at best double-digit growth, but the aim to approach EPS of CHF 80 in 2008 is no doubt a positive surprise. Moreover, we believe that the company's focus on EPS rather than "just" top line growth and margins is a warranty that management is not going to dilute interests of the shareholders.

We believe 15% to 20% EPS growth over the next three years is possible. As a result, we expect investors will change their perceptions of the company and value SGS at higher multiples.

Growth plan overview



Source: SGS

The new targets presented are clearly aggressive, yet in our view achievable. The plan is no radical revolution, being mainly based on the existing portfolio. We stress that our confidence in the growth plan is based on several factors.

One supporting factor is clearly the underlying, mainly positive trend. Recall that, over the past three years, management has fulfilled its guidance under much more difficult circumstances. Moreover, note that SGS possesses a sound balance sheet with CHF 500m in net cash (excluding treasury shares) and yearly free cash flows of CHF 200m on a rising trend. However, we believe that the balance sheet will still look very good in 2008 For the proposed plan, revenues should rise from their current CHF 3,200m to CHF 5,000m by 2008. Two-thirds or CHF 1,200m in additional turnover should be achieved internally, one-third or CHF 600m by acquisitions. SGS's track record from recent acquisitions is evidence that the company is not overpaying its targets and is not diluting margins. All recent acquisitions were concluded rapidly and successfully integrated into the existing network. The plan to spend cash for acquisitions should result in current net cash no longer being dilutive and the yield on cash should at least approach the current average ROIC.

External factors summary

Opportunities

- Underlying client segments growing
- Raw materials demand & pricing strong
- Economic forecasts positive
- Trade flows growing
- Big project investments around energy
- Regulatory climate & public awareness increase QC needs
- Outsourcing trends prevalent in many segments

Challenges

- TAS pre-shipment inspection market declining
- Standalone inspection under competitive pressure
- Competitors moving up value chain
- Slow liberalisation of government monopolies

Challenging but fertile environment for growth

Source: SGS

Following the increased visibility, we have raised our earnings forecasts and now expect EPS of CHF 75 for 2008, slightly below the new target of CHF 80. Additionally, we have raised our 12-month target price from CHF 1,100 to CHF 1,250, in line with our DCF model or 17 times projected 2008 earnings.

THE FOUR PILLARS OF THE STRATEGY

We understand the four pillars of the SGS strategy are

- Organic growth
- Strategic initiatives
- Acquisitions
- Operating efficiencies

The aim is to achieve double-digit organic growth – at least 10%. In all of SGS's 10 divisions the approach is to accelerate growth by geographical extension of the existing portfolio of services, moving the services upstream along the value chain and rebalancing the offered services.

Additionally, the company is aiming to develop four strategic markets: government and institutions, financial services, energy infrastructure and software. Software is a new area, the three other initiatives are based mainly on already existing services. As a common base along all of the four initiatives SGS is developing targeted offering bundles, building dedicated marketing and sales teams with "inside" expertise and is going to leverage the existing know-how, network and assets to deliver.

Strategic initiatives

Strategic markets	Government & Institutions	Financial services	Energy infrastructure	Software
Needs	- Waste management - Trade security & facilitation - Environmental monitoring - Quality systems - Biometrics - Public service outsourcing - Origin tracing	Project financing & underwriting: - Technical feasibility - Project & maintenance inspection Trade financing: - Bankability inspection - Custodial services Leasing: - Residual value assessment Underwriting: - Pre-loss risk assessment	- Industrial supply chain inspection & construction support - Process planning & simulation - Technical staffing - Minerals / oil & gas inspection and test - Environmental	- Functional testing - Integration testing - Standards compliance - Risk analysis - Software process certification

Source: SGS presentation, 7 November 2005

Regarding acquisitions, SGS will focus on three divisions: Life Science, Industrial and Consumer. However, bolt-on acquisitions in the current portfolio could also be necessary and planning for the strategic growth initiatives assumes support by acquisitions, at least for initiatives in the energy infrastructure and software areas.

Acquisitions

Current portfolio growth
- Targeted lab expansion in Oil, Gas & Chemical, Minerals & Environmental
- Statutory auto inspection

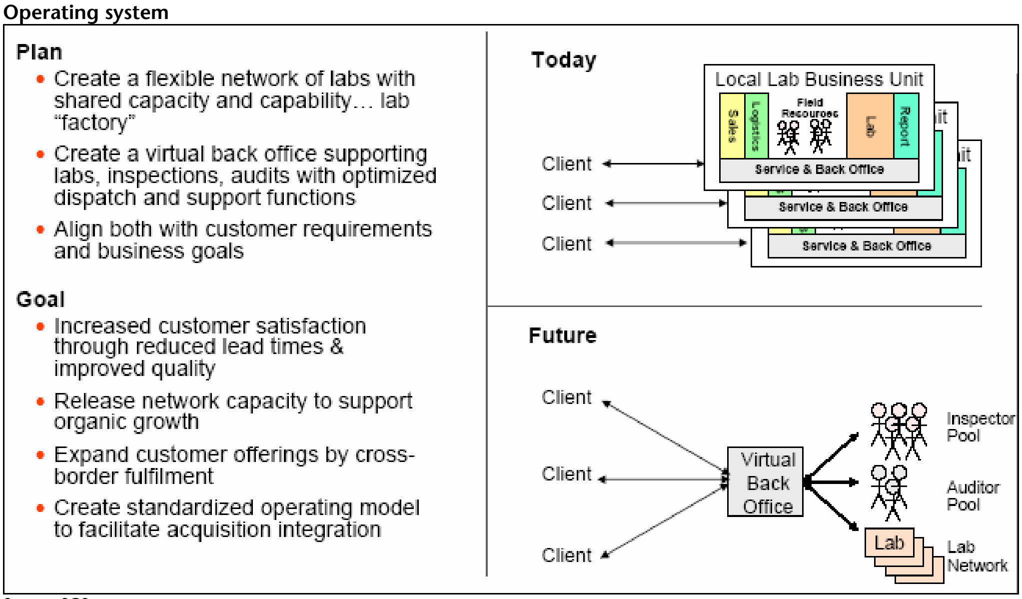
Accelerated Life Science, Industrial, Consumer growth
- Life Science… Expand QC presence in USA, expand clinical research presence in USA & Europe
- Industrial… Targeted regional acquisitions for market position
- Consumer… Strengthen E&E, enter personal care in USA & Europe

Strategic growth initiatives
- Energy Infrastructure… targeted local labs
- Software… independent QA/QC businesses

Source: SGS

Finally, efficiency of the existing operating system should be increased. The aim is to share capacity and capability and the creation of virtual back-office supporting labs.

Operating system



Source: SGS

OUR FORECASTS UNTIL 2008

For 2006, 2007 and 2008, we have slightly adapted our forecasts as follows:

Change in estimates

	2005E	2006E		2007E		2008E	
	No change	Old forecast	New forecast	Old forecast	New forecast	Old forecast	New forecast
Revenues in CHF m	3,287	3,665	3,709	4,038	4,176	4,442	4,740
Growth rate	13.9%	11.5%%	12.9%	10.2%	12.6%	10.0%	13.5%
EBITA in CHF m	495	585	593	667	692	734	806
EBITA margin	15.1%	16.0%	16.0%	16.5%	16.6%	16.5%	17.0%
EPS in CHF	46.7	54.7	55.5	62.0	64.4	n.a.	74.6

Source: Bank Leu estimates

Looking to our updated DCF model, we calculate a fair value of CHF 1,244 per share.

The most important input factors to our model are the following:

- We believe that 17.0% EBIT margin is achievable at the latest by 2008 and is sustainable.
- We believe that, after 2008, top line growth will slow to 10%. Our assumption for the perpetual growth rate (2011 ff.) is 2.5%.
- Our calculations use a cash operating tax rate of 25%, which we believe is a fairly cautious approach. According to the company, some additional measures to optimize the group's global tax position were put in place in 2004 – first benefits could be seen in 2005.
- We assume a WACC of 8.3%.
- We believe, after 2005, SGS's capex level will rise slower than initially expected, simply because we expect most of the work in building up a lab infrastructure to be complete. The pure maintenance level for the infrastructure is about CHF 100m, the rest is investment for future growth.

DCF

	2005E	2006E	2007E	2008E	2009E	2010E	2011E	Base	Rate to infinity	CAGR 95-04A	CAGR 04-11E
Revenues	**3,287**	**3,709**	**4,176**	**4,740**	**5,214**	**5,735**	**6,309**			**3.9%**	**11.8%**
growth rate	*13.9%*	*12.9%*	*12.6%*	*13.5%*	*10.0%*	*10.0%*	*10.0%*				
EBITA	**495**	**593**	**692**	**806**	**886**	**975**	**1,072**			**10.0%**	**15.5%**
as percentage of sales	*15.1%*	*16.0%*	*16.6%*	*17.0%*	*17.0%*	*17.0%*	*17.0%*				
COT	25.0%	25.0%	25.0%	25.0%	25.0%	25.0%	25.0%				
NOPAT	**347**	**415**	**484**	**604**	**665**	**731**	**804**			**10.0%**	**16.6%**
Depreciation	105	110	115	120	130	140	150				
as percentage of sales	*3.2%*	*3.0%*	*2.8%*	*2.5%*	*2.5%*	*2.4%*	*2.4%*				
Cash flow	**452**	**525**	**599**	**724**	**795**	**871**	**954**			**7.3%**	**14.4%**
Net working capital	397	448	505	573	630	693	763				
as percentage of sales	*12.1%*	*12.1%*	*12.1%*	*12.1%*	*12.1%*	*12.1%*	*12.1%*				
Decrease/(Increase) in net working capital	-70	-72	-81	-85	-91	-97	-104				
as percentage of sales	*-2.1%*	*-1.9%*	*-1.9%*	*-1.8%*	*-1.7%*	*-1.7%*	*-1.7%*				
Capex	-180	-150	-150	-150	-150	-150	-150				
as percentage of sales	*5.5%*	*4.0%*	*3.6%*	*3.2%*	*2.9%*	*2.6%*	*2.4%*				
Capex/Depreciation	*171%*	*136%*	*130%*	*125%*	*115%*	*107%*	*100%*				
Free cash flow	**202**	**303**	**368**	**489**	**554**	**624**	**700**	**700**	**12,175**	**9.5%**	**28.7%**
growth rate	*68%*	*50%*	*22%*	*33%*	*13%*	*13%*	*12%*				
Discount factor	0.924	0.853	0.853	0.728	0.673	0.621	0.574		0.574		
Discounted FCF	186	259	314	356	372	388	402		6,990		
Enterprise value	**8,866**										
+ Net cash 2005E (incl. treasury shares)	**898**										
- Minorities	**30**										
Equity value	**9,734**										
Total number of shares (in millions)	7,822,166										
Equity value per share in CHF	**1,244**										
Cost of equity:											
Beta	0.95										
Risk free rate	3.5%										
Risk premium	5.0%										
WACC=ke (cost of equity) = Rf + (Beta x Risk premium)	8.3%										
WACC	**8.3%**										
g 2011ff	**2.5%**										
Rate to infinity (=WACC-g)	5.8%										

Source: Bank Leu estimates

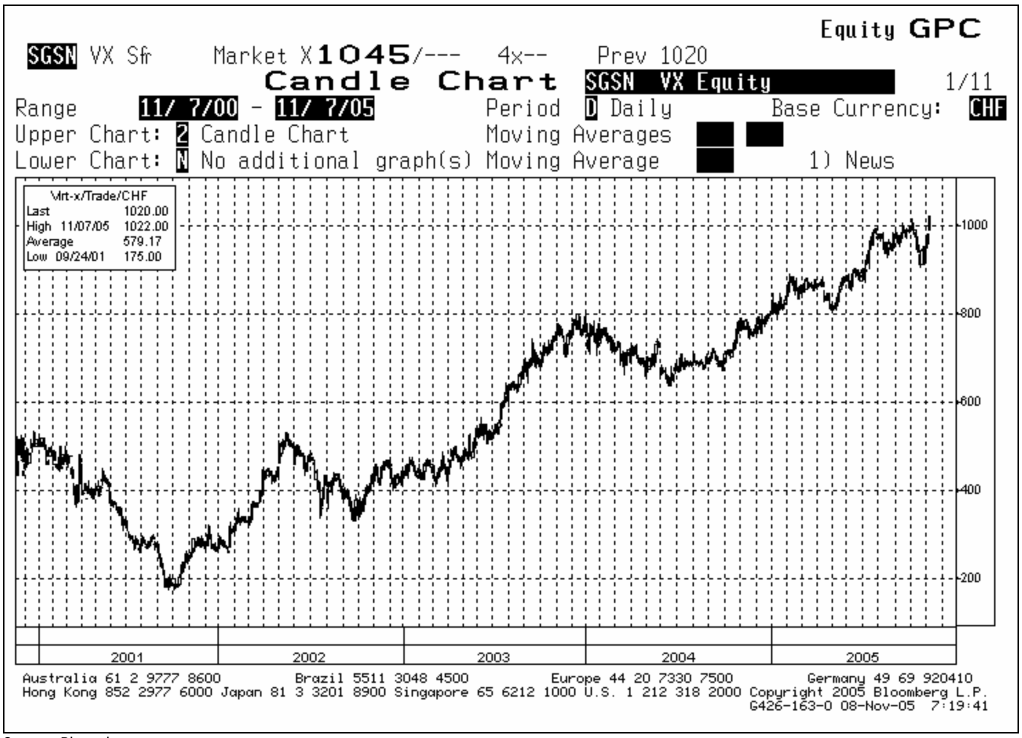
Sensitivity to our DCF

Fair value in CHF	WACC= 8.0%	WACC= 8.5%	WACC= 9.0%
rate to infinity = 3.0%	1,348	1,312	1,277
rate to infinity = 2.5%	1,246	1,228	1,196
rate to infinity = 2.0%	1,188	1,158	1,128

Source: Bank Leu estimates

SCHEDULED EVENTS

2005 Results	17 January 2006



Source: Bloomberg

BRIEF PROFILE

With over 41,000 employees and expected revenues of CHF 3.3bn in 2005, SGS is the market leader in the inspection and goods testing businesses. The company operates a network of about 1,000 offices. Its core business comprises the following divisions: inspecting, testing and verifying of agricultural products, minerals, petroleum, consumer goods, automotive services, industrial services, environmental services, life science services as well as the international certification business (ISO 9000, ISO 14000 and SA 8000) and testing imports and exports on behalf of governments and international organizations (Trade Assurance).

TABLES

Profit and loss accounts (CHF m)

	2000A	2001A	2002A	2003A	2004A	2005E	2006E	2007E	2008E
Revenues	2,369	2,332	2,392	2,454	2,885	3,287	3,709	4,176	4,740
- growth rate	-23.2%	-1.6%	2.6%	2.6%	17.6%	*13.9%*	*12.9%*	*12.6%*	*13.5%*
Salaries and wages	-1,246	-1,255	-1,252	-1,240	-1,515	-1,709	-1,921	-2,155	-2,436
Subcontractors' expenses	-147	-133	-142	-155	-162	-184	-206	-230	-258
Depreciation	-104	-101	-95	-96	-99	-105	-110	-115	-120
Other operating expenses	-715	-697	-687	-663	-718	-793	-879	-984	-1,119
Operating income (EBITA)	158	137	216	300	391	495	593	692	806
- growth rate	-18.3%	-13.2%	57.5%	38.8%	30.6%	*26.6%*	*19.7%*	*16.7%*	*16.4%*
Exceptional operating income/(expenses)	9	-178	-80	3	3	0	0	0	0
Goodwill amortization	-4	-8	-9	-10	-16	0	0	0	0
Earnings before interest and tax (EBIT)	167	-40	127	293	378	495	593	692	806
Financial revenue, net	25	17	13	10	6	7	5	5	5
Profit before taxes and minority interests	191	-23	140	303	384	502	598	697	811
Taxes	-51	-44	-27	-68	-90	-118	-141	-164	-191
Profit after taxes	140	-67	113	235	294	384	457	533	620
Minority interests	-7	-8	-4	-8	-15	-19	-23	-29	-37
Net profit	133	-75	109	227	279	366	434	504	584
- growth rate	7.0%	-156.5%	-245.0%	108.0%	23.1%	*31.0%*	*18.7%*	*16.1%*	*15.8%*

Source: Bank Leu estimates, company data

Margin analysis

	2000A	2001A	2002A	2003 A	2004A	2005 E	2006E	2007E	2008E
Revenue	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%	100.0%
Salaries and wages	52.6%	53.8%	53.7%	53.2%	52.5%	52.0%	51.8%	51.6%	51.4%
Subcontractors' expenses	6.2%	5.7%	6.1%	6.6%	5.6%	5.6%	5.6%	5.5%	5.5%
Other operating expenses	30.2%	29.9%	29.4%	28.4%	24.9%	24.1%	23.7%	23.6%	23.6%
EBITDA	11.0%	10.2%	13.0%	16.1%	17.0%	18.3%	19.0%	19.3%	19.5%
Depreciation	4.4%	4.3%	4.0%	3.9%	3.4%	3.2%	3.0%	2.8%	2.5%
EBITA	6.7%	5.9%	9.0%	12.3%	13.6%	15.1%	16.0%	16.6%	17.0%
Amortization	0.2%	0.4%	0.4%	0.4%	0.6%	0.0%	0.0%	0.0%	0.0%
EBIT	6.5%	5.5%	8.7%	11.9%	13.0%	15.1%	16.0%	16.6%	17.0%
Tax rate	26.9%	-187.1%	19.3%	22.5%	23.5%	23.5%	23.5%	23.5%	23.5%
Net profit	5.6%	-3.2%	4.6%	9.2%	9.7%	11.1%	11.7%	12.1%	12.3%

Source: Bank Leu estimates, company data

Balance sheet (CHF m)

	2000A	2001A	2002A	2003A	2004A	2005E	2006E	2007E	2008E
Fixed assets	512	545	569	682	927	973	1,022	1,073	1,127
Current assets	1,610	1,445	1,281	1,340	1,285	1,580	1,937	2,351	2,841
Total assets / s/h' equity and liabilities	2,122	1,991	1,850	2,022	2,212	2,554	2,959	3,424	3,968
Shareholders' equity	1,099	982	897	1,072	1,229	1,485	1,789	2,141	2,550
Minority interests	20	26	18	18	26	30	30	30	30
Long-term liabilities	358	312	320	292	257	250	250	250	250
Current liabilities	644	671	615	640	700	789	890	1,002	1,138

Source: Bank Leu estimates, company data

Cash flows (CHF m)

	2000A	2001A	2002A	2003A	2004A	2005E	2006E	2007E	2008E
Net profit/(loss)	133	-75	109	227	279	366	434	504	584
Goodwill amortization	4	8	9	20	33	0	0	0	0
Depreciation	104	101	89	86	98	105	110	115	120
Financial income, net	-25	-17	-13	-10	-6	-7	-5	-5	-5
Changes in provisions	-78	-34	-12	-2	-21	-11	0	0	0
Taxes	51	44	27	67	90	118	141	164	191
Other adjustments	-2	184	10	7	13	0	0	0	0
Working capital movements	-206	-76	32	-70	-61	-70	-72	-81	-92
Net cash from operating activities	-18	135	251	325	425	501	607	697	797
CAPEX	-122	-117	-121	-171	-201	-180	-150	-150	-150
Acquisitions/Disposals, net	-9	-20	-54	-31	-194	-25	0	0	0
Interest and dividends received	37	27	27	17	13	15	15	15	15
Others	-4	60	30	84	67	0	0	0	0
Net cash (used in) investing activities	-98	-51	-118	-101	-315	-190	-135	-135	-135
Payment of dividend	-38	-45	-47	-56	-69	-95	-117	-141	-164
Purchase of treasury shares	0	0	-62	0	-15	0	0	0	0
Interest paid	-13	-10	-12	-9	-7	-12	-12	-12	-12
Others	14	24	-87	-107	-42	0	0	0	0
Net cash (used in) financing activities	-36	-31	-208	-172	-133	-107	-129	-153	-176
Net (Decrease)/Increase of cash and cash equivalents	-152	53	-75	52	-23	204	343	409	486
Translation adjustments, forex	-3	-6	44	0	-2	0	0	0	0
Cash and cash equivalents at 1 January	598	442	490	419	471	446	650	993	1,402
Cash and cash equivalents at 31 December	442	490	419	471	446	650	993	1,402	1,888

Source: Bank Leu estimates, company data

Financial ratios

	2000A	2001A	2002A	2003A	2004A	2005E	2006E	2007E	2008E
Self-financing ratio	51.8%	49.3%	48.5%	53.0%	55.6%	58.1%	60.5%	62.5%	64.3%
Current ratio	250%	215%	208%	209%	184%	200%	218%	235%	250%
Investment cover ratio 1	215%	180%	158%	157%	133%	153%	175%	200%	226%
Investment cover ratio 2	285%	237%	214%	200%	160%	178%	199%	223%	248%
CAPEX/Depreciation	118%	115%	136%	199%	205%	171%	136%	130%	125%
ROE	12.7%	-7.2%	11.6%	23.0%	24.3%	26.9%	26.5%	25.6%	24.9%
ROA	6.1%	-3.7%	5.7%	11.7%	13.2%	15.3%	15.7%	15.8%	15.8%
NOPAT margin	4.7%	4.1%	6.3%	8.6%	9.5%	10.6%	11.2%	11.6%	11.9%
Invested capital turn	2.53	2.57	2.81	2.57	2.49	2.51	2.78	3.19	3.73
ROIC	11.8%	10.6%	17.8%	22.2%	23.7%	26.5%	31.1%	37.0%	44.4%
WACC	10.2%	10.2%	9.2%	8.8%	8.8%	8.8%	8.8%	8.8%	8.8%
Spread	1.6%	0.4%	8.6%	13.4%	14.9%	17.6%	22.2%	28.1%	35.6%

Source: Bank Leu estimates, company data