Services Group
Diversified Commercial

Switzerland

SGS (VX: SGSN VX)

Mixed H1, but Optimism Reigns

Investment Summary

While H1 results were underwhelming, the SGS story remains intact with solid industry drivers (increased global trade flows, outsourcing and regulation, along with a fragmented market) mixed with professional execution.

Company Update
Estimate Change

Rating:	BUY
Price:	CHF1,485.00
Price Target:	CHF1,800.00
Bloomberg:	VX: SGSN VX

Market Data

52-Week Range:	CHF1,628.00-CHF1,063.00
Total Entprs. Value (MM):	CHF10,898.0
Market Cap. (MM):	CHF11,286.0
Shares Out. (MM):	7.6
Avg. Daily Vol.:	23,667

Financial Summary

Net Debt (MM):	(CHF388.0)
Net Debt/Capital:	(20.0%)
Dividend Yield:	1.5%

CHF	2005A	2006A	2007E	2008E
Rev. (MM)	3308.0	3821.0	4337.0	4844.0
Prev.	--	--	*4306.0*	*4811.0*
EV/Rev.	3.3x	2.9x	2.5x	2.2x
EBITDA (MM)	642.0	800.0	893.0	1,024.0
Prev.	--	--	*899.0*	*1,018.0*
EV/EBITDA	17.0x	13.6x	12.2x	10.6x
EPS				
FY Dec	**48.90**	**58.40**	**65.89**	**76.79**
Prev. FY	--	--	*66.60*	*77.10*
FY P/E	30.4x	25.4x	22.5x	19.3x
EBIT (MM)	502.0	624.0	697.0	808.0
Prev.	--	--	*702.0*	*807.0*
EV/EBIT	21.7x	17.5x	15.6x	13.5x
Net Profit	371.0	443.0	503.0	586.0
Prev.	--	--	*506.0*	--
Consensus	—	—	66.30	75.60

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Event

SGS reported mixed H1 results with better than expected revenues (CHF2.089 vs. our CHF2.067 forecast), but weaker than expected operating margins (15.5% vs. our expected 16.3%). Guidance unchanged.

Key Points

- Sales were the bright point of the H1 release with revenue for the half of CHF2.089b vs. our CHF2.067 estimate on organic growth of 11.5% vs. our 11.1% estimate. Driving better than expected sales were good results from the Industrial, Government and Automotive divisions, while the Consumer, Life Sciences and Agricultural businesses were weaker than expected. (See page 2 for further detail)
- Despite the good top line, EBIT was a disappointing CHF324m vs. our CHF336m forecast and reflecting an EBIT margin of 15.5% vs. our 16.3% forecast. Weakness in margins came in large part due to mix (good growth in lower margin businesses and regions – ie. non-Asian). By division, there was margin weakness in consumer testing (22.1% margin vs. 23.5% expected) as a result of the exceptional '06 RoHS business and also in the Life Sciences (weaker volumes) and Environmental businesses.
- Given the weaker than expected EBIT, EPS for the half was CHF30.62 vs. our forecast of CHF31.82.
- **Guidance maintained.** While disappointed with the H1 margin progression, we continue to see significant room for margin expansion and were encouraged by management's optimistic outlook for H2. Along with lesser headwinds in the consumer business, management guided to margin expansion in the majority of the company's 10 divisions. Looking further ahead, management reiterated its 2008 guidance for CHF5b in revenues, 17% EBIT margin and CHF80 in EPS which remains well above consensus estimates (and our own).
- We have slightly adjusted our forward estimates to reflect the H1 results, but continue to expect to see good margin expansion through '08. We have also adjusted our top line to reflect better than expected organic growth, the impact of which is somewhat offset by slower than expected acquisitions.

Valuation/Risks

Our target price of CHF1800 implies a 23x multiple of '08 earnings - a premium to Intertek given what we see as SGS's faster growth prospects and better margin expansion opportunities. Key risks to our thesis include a downturn in the global economy leading to reduced trade flows and/or lower commodity prices.

Top-line Details. Revenue for the half was CHF2.089b, exceeding our estimate of CHF2.067 and driven by organic growth of 11.5% vs. our 11.1% estimate. Contribution from acquisitions was 0.3% over the half vs. our 0.9% forecast (due to unannounced divestitures in the agriculture and industry businesses), while currency had a positive impact in the half of +1.7%. By division, good performances in the period came from:

- Industrial Services (+19% LFL vs. our 12% forecast) which benefited from strong European demand, increased business related to wind energy, and also good performance from SRS (leak testing for LNG vessels) which was acquired in 2006;
- Government Services (+13.8% LFL vs. our -6% forecast) which benefited from the exit of the lost Nigerian and Venezuelan contracts from the perimeter, the commencement of a new Angolan contract and from generally good take-up of non-PSI services;
- Automotive Service (+7.5% LFL vs. our 3% forecast) which was driven by the start of black cab contract in London;
- and the Environmental Services division (+13.1% LFL vs. our 7.5% forecast).

Disappointments over the period came from:

- Consumer Testing (+8.6% LFL vs. our 15% forecast) which had a tough comparable period due to very strong '06 RoHS business (estimated at CHF11m in H1'06);
- Agricultural Services (+2.4% LFL vs. our 10% forecast) which was hindered by weak crop yields;
- and the Life Sciences division (+5.1% LFL vs. our 10% forecast) which experienced weakness in France with the implementation of the European clinical trials directive in mid '06.

After significantly outperforming the other regions over the past five years the Asia Pacific region grew 13% LFL vs. 11.5% in EMEA and 10% in the Americas. Along with reflecting the RoHS situation and a slowly maturing Asian business, this re-equilibrium by region is indicative of the ongoing global commodities boom which has particularly benefited the non-Asian regions.

An acquisition update. Management's update on acquisition progress highlighted the challenges currently faced by industry players. On the positive side, CEO Chris Kirk noted that SGS is currently looking at 41 transactions and continues to expect to announce some progress shortly. However, price continues to be an issue, notably for larger deals which are being aggressively pursued by private equity players. Management noted that it had been interested in Applus+, but, like Bureau Veritas, are no longer in the running given the transaction's inflated price tag. Finland based Inspecta, for which management had also recently noted interest, was also recently acquired by 3i.

In terms of a transforming deal, management reiterated that they could be interested in Bureau Veritas. As we have noted in previous comments, we believe this transaction makes strategic sense for both players and believe SGS could pay a price above its own multiple and still make the deal accretive.

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Growth Analysis	H1 06	H2 06	FY 06	H1 07	H1 07 - Jef. Est.
Perimeter Effect %	4.3%	3.0%	3.6%	0.3%	0.9%
Currency effect %	3.8%	-0.4%	1.6%	1.7%	0.0%
LFL %	10.4%	10.2%	10.3%	11.5%	11.1%
Total (%)	**18.5%**	**12.9%**	**15.5%**	**13.5%**	**12.0%**

Revenue - by Division	H1 06	H2 06	FY 06	H1 07	H1 07 - Jef. Est.
Agricultural Services	156.7	160.2	316.9	167.7	173.2
% LFL Growth	9.3%	2.6%	5.7%	2.4%	10.0%
Minerals Services	225.3	241.7	467.0	259.6	260.4
% LFL Growth	18.1%	14.1%	15.9%	11.7%	15.0%
Oil, Gas & Chemical Services	374.3	409.1	783.4	434.1	429.0
% LFL Growth	13.4%	14.2%	13.2%	13.7%	13.0%
Life Sciences Services	94.0	99.4	193.4	98.4	103.4
% LFL Growth	-1.8%	12.5%	9.2%	5.1%	10.0%
Consumer Testing Services	283.4	309.3	592.7	311.4	337.5
% LFL Growth	27.1%	17.1%	21.7%	8.6%	15.0%
Systems & Services Certification	151.4	167.3	318.7	170.1	169.6
% LFL Growth	15.7%	13.8%	14.7%	10.6%	12.0%
Industrial Services	240.2	270.2	510.4	298.4	275.7
% LFL Growth	11.5%	14.4%	13.1%	19.0%	12.0%
Environmental Services	125.0	124.2	249.2	133.4	124.5
% LFL Growth	6.9%	6.2%	6.5%	13.1%	7.5%
Automotive Services	111.5	108.8	220.3	121.7	114.8
% LFL Growth	3.3%	4.9%	4.0%	7.5%	3.0%
Trade Assurance Services	83.3	85.7	169.0	94.0	78.3
% LFL Growth	-30.7%	-20.9%	-26.1%	13.8%	-6.0%
Total Revenue	**1845.6**	**1976.0**	**3821.6**	**2088.8**	**2067.0**
Growth	18.5%	12.9%	15.5%	13.2%	12.0%
LFL Growth	10.4%	10.2%	10.3%	11.5%	11.1%

Operating Profit - by Division	H1 06	H2 06	FY 06	H1 07	H1 07 - Jef. Est.
Agricultural Services	18.7	20.7	39.4	19.0	21.7
% Margin	11.9%	12.9%	12.4%	11.3%	12.5%
Minerals Services	37.6	42.9	80.5	43.2	46.9
% Margin	16.7%	17.7%	17.2%	16.6%	18.0%
Oil, Gas & Chemical Services	51.9	60.7	112.6	65.2	60.1
% Margin	13.9%	14.8%	14.4%	15.0%	14.0%
Life Sciences Services	11.4	13.2	24.6	11.0	14.5
% Margin	12.1%	13.3%	12.7%	11.2%	14.0%
Consumer Testing Services	64.6	72.2	136.8	68.7	79.3
% Margin	22.8%	23.3%	23.1%	22.1%	23.5%
Systems & Services Certification	27.7	31.2	58.9	28.5	31.4
% Margin	18.3%	18.6%	18.5%	16.8%	18.5%
Industrial Services	31.5	43.2	74.7	46.8	41.4
% Margin	13.1%	16.0%	14.6%	15.7%	15.0%
Environmental Services	11.3	12.8	24.1	11.8	13.7
% Margin	9.0%	10.3%	9.7%	8.8%	11.0%
Automotive Services	15.3	14.5	29.8	16.4	15.5
% Margin	13.7%	13.3%	13.5%	13.5%	13.5%
Trade Assurance Services	11.4	11.8	23.2	13.2	11.7
% Margin	13.7%	13.8%	13.7%	14.0%	15.0%
Total Operating Profit	**281.4**	**323.2**	**604.6**	**323.8**	**336.0**
% Margin	15.2%	16.4%	15.8%	15.5%	16.3%

Source: Jefferies Int'l

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Income Statement (CHFm)	2004	2005	2006	2007E	2008E	2009E
Year to December						
Turnover	2885.0	3,308	3,821	4,337	4,844	5,417
% change	17.6%	14.7%	15.5%	13.5%	11.7%	11.8%
EBITDA	508.0	642.0	800.0	893.4	1,024.1	1,152.4
margin %	17.6%	19.4%	20.9%	20.6%	21.1%	21.3%
EBIT	380.0	502.0	624.0	696.8	807.9	919.0
margin %	13.2%	15.2%	16.3%	16.1%	16.7%	17.0%
Pre-Tax	386.0	507.0	623.0	698.8	813.9	925.0
Net income	278.0	371.0	443.0	503.1	586.4	668.7
margin %	9.6%	11.2%	11.6%	11.6%	12.1%	12.3%

Balance Sheet (CHFm)	2004	2005	2006	2007E	2008E	2009E
Working Capital	139.0	223.0	219.0	321.6	401.2	448.6
WC as a % of turnover	4.8%	6.7%	5.7%	7.4%	8.3%	8.3%
Capital Employed & goodwill	936.0	1238.0	1519.0	1769.0	2004.6	2234.7
RoACE incl GW	44.9%	46.2%	45.3%	42.4%	42.8%	43.4%
ROE	25.2%	27.0%	30.6%	27.8%	26.6%	25.1%
Net Debt	-438.0	-430.0	-216.0	-362.1	-546.8	-791.2
Gearing	-37.7%	-29.9%	-14.1%	-19.2%	-23.8%	-28.6%

Cash Flow (CHFm)	2004	2005	2006	2007E	2008E	2009E
Cash Flow	486.0	598.0	583.0	705.7	811.7	912.1
Capex	-201.0	-205.0	-224.0	-251.2	-242.2	-270.8
WCR	-61.0	-187.0	-31.0	-114.6	-79.5	-47.4
Free-Cash Flow	224.0	206.0	328.0	339.9	489.9	593.9

Key Valuation Ratios	2004	2005	2006	2007E	2008E	2009E
Shares Outstanding (m)	7.49	7.59	7.59	7.64	7.64	7.64
Stock Price (CHF)	721	956	1,226	1,480	1,480	1,480
Market Cap*	5395.8	7,260	9,307	12,065	12,065	12,065
EPS net	37.1	48.9	58.4	65.9	76.8	87.6
PER net	19.4	19.6	21.0	22.5	19.3	16.9
CFPS	64.90	78.74	76.80	92.42	106.29	119.45
PCF	11.1	12.1	16.0	16.0	13.9	12.4
P/NAV	4.6	5.0	6.1	6.4	5.2	4.4
ROE	25.2%	27.0%	30.6%	27.8%	26.6%	25.1%
EV	4957.8	6,830	9,091	10,939	10,754	10,510
EV / Sales	171.8%	206.5%	237.9%	252.2%	222.0%	194.0%
EBIT mg %	13.2%	15.2%	16.3%	16.1%	16.7%	17.0%
EV / EBITDA	9.8	10.6	11.4	12.2	10.5	9.1
EV / EBIT	13.0	13.6	14.6	15.7	13.3	11.4
Yield %	1.3%	1.2%	4.2%	1.4%	1.6%	1.8%

* historical datas are average figures

source: Jefferies International Ltd.

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Company Description
SGS provides inspection, testing, verification and certification services worldwide. Through its international network of laboratories, the company inspects, samples and analyses raw materials, food, crops and consumer goods, as well as certifying products and machinery for compliance with local and international standards. Based in Geneva, SGS reported 2006 revenues of CHF 3.8b, and employs over 40,000 people worldwide.

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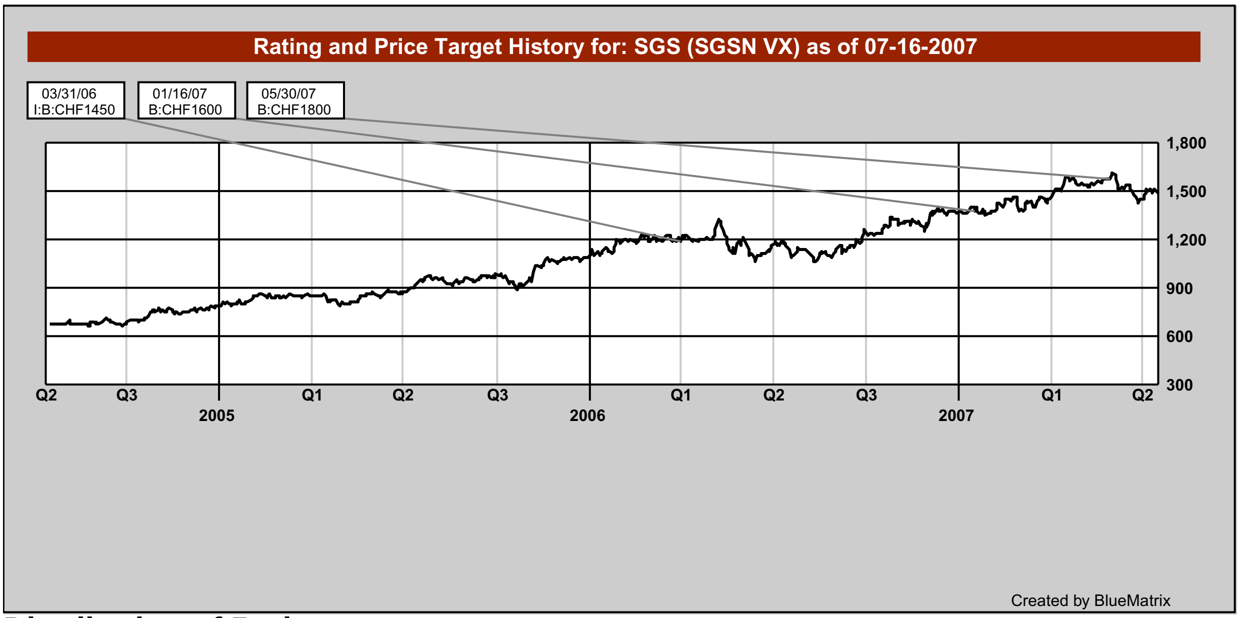

Distribution of Ratings

Rating	Count	Percent	IB Serv./Past 12 Mos. Count	IB Serv./Past 12 Mos. Percent
BUY [BUY/SB]	442	55.11	55	12.44
HOLD [HOLD]	327	40.77	31	9.48
SELL [UNPF/SU]	33	4.11	4	12.12

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