

Services Group  
Diversified Commercial

Switzerland

**Company Update**  
**Price Target Change**  
**Estimate Change**

Rating: BUY  
Price: CHF1,291.00  
Price Target: CHF1,600.00  
*Previous:* CHF1,800.00  
Bloomberg: VX: SGSN VX

**Market Data**

52-Week Range: CHF1,628.00-CHF1,199.00  
Total Entprs. Value (MM): CHF9,202.6  
Market Cap. (MM): CHF9,811.6  
Shares Out. (MM): 7.6  
Avg. Daily Vol.: 23,667

**Financial Summary**

Net Debt (MM): (CHF609.0)  
Net Debt/Capital: (20.0%)  
Dividend Yield: 2.5%

CHF	2006A	2007E	2008E	2009E
Rev. (MM)	3821.0	4372.0	4830.9	5435.8
<i>Prev.</i>	--	4337.0	4788.0	5395.0
EV/Rev.	2.4x	2.1x	1.9x	1.7x
EBITDA (MM)	800.0	908.0A	1,034.5	1,155.6
<i>Prev.</i>	--	893.0	1,031.0	1,159.0
EV/EBITDA	11.5x	10.1x	8.9x	8.0x
<b>EPS</b>				
<b>FY Dec</b>	<b>58.40</b>	<b>65.47A</b>	<b>75.83</b>	<b>87.06</b>
<i>Prev. FY</i>	--	65.86	76.73	88.58
FY P/E	22.1x	19.7x	17.0x	14.8x
EBIT (MM)	624.0	690.0A	800.5	914.5
<i>Prev.</i>	--	697.0	805.0	922.0
EV/EBIT	14.7x	13.3x	11.5x	10.1x
Net Profit	443.0	500.0A	579.1	664.9
<i>Prev.</i>	--	503.0	586.0	676.0

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## SGS (VX: SGSN VX)

### Battling Back to a Premium Valuation

#### Investment Summary

Solid 2007 results and encouraging guidance reinforce our belief in SGS's top and bottom line expansion potential. Trading significantly off 2007 highs and at a large discount to our DCF valuation we reiterate our Buy recommendation.

#### Event

SGS held an upbeat analyst meeting following the publication of its 2007 results.

#### Key Points

- 2007 results published yesterday by SGS were solid, with better than expected metrics across the board. Sales of CHF4.37b featured 12% organic growth vs. our 11.6% forecast with a notable acceleration in lfl growth to 12.4% in H2 vs. 11.5% in H1. Group operating margin of 16.3% was ahead of our 16.1% estimate while normalized EPS of CHF67.37 handily beat our CHF65.86 estimate. We have more fully over-viewed the results on the following page.
- Guidance provided during the analyst meeting was upbeat. While moving away (as expected) from the previous CHF80 in '08 target, management noted that it expects 10%+ organic growth in 2008 (vs. our previous 9.6% forecast) and also expects to see further margin improvement. Longer term, management set a goal for EPS of CHF105 in 2011 – an earnings CAGR of 11.7%. We would view this target as a minimum and believe it reflects solely organic expansion and management caution following the issues surrounding previous '08 guidance.
- Along with the guidance, other noteworthy elements of the meeting were management's assertion that acquisition multiples could come down in 2008 and also the company's discussion of its exposure to cyclicity. The company highlighted; 1) that its exposure to trade volumes is decreasing as it moves into higher value added services, 2) the defensive nature of the pharma and environmental businesses (>10% of revenues), and 3) the ongoing strength in commodity markets (>40% of sales).
- While impressed by the results, we have made mixed adjustments to our forecasts – reflecting potential macroeconomic challenges in the year ahead. While increasing our sales figures, we have decreased our margin assumptions slightly for '08 and beyond and our EPS is slightly decreased on lower expected financial income.

#### Valuation/Risks

Following the results release and positive stock reaction, we continue to believe SGS is most attractive of the large testing players. However, based on tougher market conditions, we have decreased our target price to CHF1,600 reflecting the mid point (21x) of SGS's 2007 trading range. That valuation is supported by our CHF1,690 DCF. Trading at a 7% premium to BV's '08 PE we believe the gap is justified given SGS's more limited exposure to the current global macroeconomic headwinds.

Risks include a slowdown in the global economy or in global trade flows.

As noted above, SGS's 2007 results were solid across the board. Sales of CHF4.37b were up 14.4% y/y and ahead of our CHF4.34b forecast. Organic growth of 12% firmly outpaced our 11.6% forecast with a notable acceleration in lfl growth to 12.4% in H2 vs. 11.5% in H1. Group EBIT before a CHF21m charge for restructuring was CHF711m, well above our CHF697 forecast. Operating margin of 16.3% was ahead of our 16.1% estimate with better than expected performance from the Consumer, Systems and Certification and GIS divisions. On the bottom line, normalized EPS of CHF67.37 handily beat our CHF65.86 estimate. Reviewing by division:

- The **Agricultural** division reported sales of CHF356.5m, with organic growth of 4.3% vs. our 5.2% forecast. The division was hit by export restrictions on agricultural exports from Eastern Europe in Q4 and by market upheaval as a result of biofuels production. While sales were slightly disappointing, margin in the division increased 100bps y/y to 13.4% and exceeded our 12.1% estimate. The division continues to benefit from its progress up the agricultural value chain and at the same time margins are benefiting from a buoyant global agricultural pricing.
- The **Minerals** division was one of the key positive surprises on the year with organic sales growth of 17.3%, well ahead of our 13.2% forecast. H2 organic growth exceeded 20% on the back of strong metals markets and an aggressive global minerals exploration push. The division's 17.5% margin exceeded our 17.2% forecast as the division appears to continue to enjoy strong pricing power. Looking forward the division should benefit from significant capex undertaken in '07, but faces margin headwinds as a result of wage inflation in the minerals industry.
- The **Oil, Gas & Chemicals** division was one of the few disappointments with organic sales growth of 12.5% missing our 13.9% forecast despite extremely strong oil prices. FY margin in the division of 15%, while up 60bps y/y was below our 15.5% estimate and marked a pullback from the 16% margin recorded in H1. Margin erosion in the division was partly ascribed to higher labour costs in what is a very tight global market.
- The **Life Sciences** division reported organic sales growth of 4.2%, slightly below our 6.6% estimate as the division ran into some delays in accreditation and challenges in the clinical research business. Operating margin of 12% in the division was slightly below our 12.3% forecast as the division continues to be weighed down by losses in its newly opened Asian facilities – which the company believes should be profitable this year.
- The **Consumer Testing** business provided mixed performance for the year with organic growth of 10.1% slightly missing our 10.4% forecast, but better operating margin of 23.2% vs. our 22.6% forecast. While hit by a tough comparison period which benefited from very strong RoHS revenues, good testing volumes and pricing stemming from the H2 Asian recall crises buoyed results. Looking ahead, the company noted continued strong pricing trends in the hardline and textile businesses as a repercussion of the Asian issues.
- The **Systems & Certification** division, while missing our organic growth forecast of 10.3%, reported a very strong 18.4% margin which matched the FY'06 result. SGS did note pricing pressure in the ISO9000 business as the standard matures, but 2008 should benefit from the 3yr. renewal cycle.
- The **Industrial Services** division reported a solid organic growth and margin uptick – in line with our forecasts for the year. The business continues to benefit from extremely strong energy markets (particularly wind farm driven revenues) and from good shipbuilding trends globally.
- The **Environmental Services** division reported solid organic growth of 13.8% for the FY, well ahead of our 11.6% forecast. The better result was driven by good environmental compliance business related to the mining industry and a number of contract wins in Europe. Margin in the business, at 9.8%, was in line with our forecast.
- The **Automotive Services** division reported better than expected organic growth of 10.3%, driven by good trends and market share gains in the statutory inspection business. Along with statutory inspection wins in Morocco and China, the division also publicized an acquisition in Algeria in the statutory inspection market and one in Slovenia. Margins in the division were flat y/y and in line with expectations.
- The **Government & Institutions Services** division was another positive surprise. The division reported organic growth of 19.8%, well above our 11.9% forecast as the business recovered well from the lost contracts which hurt 2006 results. While the loss of the Ecuadorian business will impact growth in 2008 (transfer of customs functions is expected in February), the transition to the scanners business appears to be progressing well.

Other notable elements of the earnings release were:

- A dividend payout of CHF35 (vs. our CHF23 estimate) composed of a CHF25 normal dividend and CHF10 special dividend. The company reiterated that it will return excess cash to investors if investment opportunities do not materialize. Management did note that it expects the company's balance sheet to naturally re-lever in the mid-term as a result of dividends, capex and a more rapid acquisition pace.
- Capex spending of CHF271 (6.2% of sales) vs. our CHF258 forecast. The capex level, which the company expects to maintain between 5-7% over the longer term, reflects aggressive organic build-out of facilities given the lack of reasonable priced external opportunities. Capex was heaviest in the Minerals (26% of total capex), Consumer, and OG&C divisions where SGS is seeing firm markets.
- Solid cash management, with an inflow from working capital despite strong top line expansion. Net cash at year's end was CHF378m vs. our CHF367 forecast.

	FY 06 Actual	FY 07 Actual	FY 07 Jefco Est.
<b>Agricultural Services</b>			
Sales	316.9	356.5	348.9
LFL Growth (%)	5.7%	4.3%	5.2%
Operating Profit	39.4	47.6	42.2
Operating Margin	12.4%	13.4%	12.1%
<b>Minerals Services</b>			
Sales	467.0	559.8	532.7
LFL Growth (%)	15.9%	17.0%	13.2%
Operating Profit	80.5	98.2	91.7
Operating Margin	17.2%	17.5%	17.2%
<b>Oil, Gas &amp; Chemical Services</b>			
Sales	783.4	891.3	903.8
LFL Growth (%)	13.2%	12.4%	13.9%
Operating Profit	112.6	133.4	140.3
Operating Margin	14.4%	15.0%	15.5%
<b>Life Sciences Services</b>			
Sales	193.4	200.4	208.5
LFL Growth (%)	9.2%	4.2%	6.6%
Operating Profit	24.6	24.1	25.6
Operating Margin	12.7%	12.0%	12.3%
<b>Consumer Testing Services</b>			
Sales	592.7	654.7	664.9
LFL Growth (%)	21.7%	10.2%	10.4%
Operating Profit	136.8	151.9	150.0
Operating Margin	23.1%	23.2%	22.6%
<b>Systems &amp; Services Certification</b>			
Sales	318.7	353.5	357.1
LFL Growth (%)	14.7%	9.0%	10.3%
Operating Profit	58.9	65.0	61.2
Operating Margin	18.5%	18.4%	17.1%
<b>Industrial Services</b>			
Sales	510.4	624.7	620.8
LFL Growth (%)	13.1%	15.8%	16.4%
Operating Profit	74.7	100.6	100.0
Operating Margin	14.6%	16.1%	16.1%
<b>Environmental Services</b>			
Sales	249.2	281.1	273.9
LFL Growth (%)	6.5%	14.1%	11.6%
Operating Profit	24.1	27.6	26.6
Operating Margin	9.7%	9.8%	9.7%
<b>Automotive Services</b>			
Sales	220.3	249.2	238.8
LFL Growth (%)	4.0%	10.2%	6.8%
Operating Profit	29.8	33.8	32.2
Operating Margin	13.5%	13.6%	13.5%
<b>Trade Assurance Services</b>			
Sales	169.0	200.4	187.2
LFL Growth (%)	-26.1%	20.0%	11.9%
Operating Profit	23.2	28.8	26.7
Operating Margin	13.7%	14.4%	14.3%

Total	FY 06 Actual	FY 07 Actual	FY 07 Jefco Est.
Revenues	3,822	4,372	4,337
% Growth	15.5%	14.4%	13.5%
LFL Growth (%)	10.3%	12.0%	11.6%
Perimeter Effect (%)	3.6%	0.9%	0.7%
Currency Impact (%)	1.6%	-1.5%	1.3%
Operating Profit	604.6	711.0	696.6
Operating Margin	15.8%	16.3%	16.1%
Net Profit	431.0	515.0	502.9
EPS	56.83	67.37	65.86

Source: Company data and Jefferies Research

December year end	2002	2003	2004	2005	2006	2007	2008E	2009E	2010E
<b>Income Statement (CHFm)</b>									
Turnover	2392.0	2454.0	2885.0	3308.0	3821.0	4372.0	4830.9	5435.8	6098.1
% change	2.6%	2.6%	17.6%	14.7%	15.5%	14.4%	10.5%	12.5%	12.2%
EBITDA	311.0	396.0	508.0	642.0	800.0	908.0	1034.5	1155.6	1316.2
margin %	13.0%	16.1%	17.6%	19.4%	20.9%	20.8%	21.4%	21.3%	21.6%
EBIT	127.0	293.0	380.0	502.0	624.0	690.0	800.5	914.5	1042.0
margin %	5.3%	11.9%	13.2%	15.2%	16.3%	15.8%	16.6%	16.8%	17.1%
Pre-Tax	140.0	303.0	386.0	507.0	623.0	692.0	804.2	919.9	1049.3
Net income	109.0	227.0	278.0	371.0	443.0	500.0	579.1	664.9	761.0
margin %	4.6%	9.3%	9.6%	11.2%	11.6%	11.4%	12.0%	12.2%	12.5%
<b>Balance Sheet (CHFm)</b>									
Working Capital	216.0	196.0	139.0	223.0	219.0	191.0	213.3	240.0	269.2
WC as a % of turnover	9.0%	8.0%	4.8%	6.7%	5.7%	4.4%	4.4%	4.4%	4.4%
Capital Employed & goodwill	696.0	758.0	936.0	1238.0	1519.0	1645.0	1789.9	2035.1	2306.8
RoACE incl GW	17.7%	40.3%	44.9%	46.2%	45.3%	43.6%	46.6%	47.8%	48.0%
ROE	12.6%	21.9%	25.2%	27.0%	30.6%	27.0%	27.0%	25.8%	24.9%
Net Debt	-402.0	-493.0	-438.0	-430.0	-216.0	-418.0	-609.0	-821.9	-1071.3
Gearing	-44.8%	-46.0%	-37.7%	-29.9%	-14.1%	-21.7%	-27.2%	-30.8%	-33.8%
<b>Cash Flow (CHFm)</b>									
Cash Flow	219.0	395.0	486.0	598.0	583.0	694.0	837.2	931.0	1061.1
Capex	-121.0	-171.0	-201.0	-205.0	-224.0	-271.0	-279.8	-314.8	-353.2
WCR	32.0	-70.0	-61.0	-187.0	-31.0	12.0	-22.3	-26.7	-29.2
Free-Cash Flow	130.0	154.0	224.0	206.0	328.0	435.0	535.1	589.5	678.7
<b>Key Valuation Ratios</b>									
Shares Outstanding (m)	7.8	7.7	7.5	7.6	7.6	7.6	7.6	7.6	7.6
Stock Price (CHF)	388.5	604.0	720.5	956.0	1,226	1,291	1,291	1,291	1,291
Market Cap*	3,020	4,644	5,396	7,260	9,307	9,859	9,859	9,859	9,859
EPS net	14.02	29.52	37.12	48.85	58.36	65.47	75.83	87.06	99.64
PER net	27.7	20.5	19.4	19.6	21.0	19.7	17.0	14.8	13.0
CFPS	28.2	51.4	64.9	78.7	76.8	90.9	109.6	121.9	138.9
PCF	13.8	11.8	11.1	12.1	16.0	14.2	11.8	10.6	9.3
P/NAV	3.4	4.3	4.6	5.0	6.1	5.1	4.4	3.7	3.1
ROE	12.6%	21.9%	25.2%	27.0%	30.6%	27.0%	27.0%	25.8%	24.9%
EV	2,618	4,151	4,958	6,830	9,091	9,441	9,250	9,037	8,788
EV / Sales	1.1	1.7	1.7	2.1	2.4	2.2	1.9	1.7	1.4
EBIT mg %	5.3%	11.9%	13.2%	15.2%	16.3%	15.8%	16.6%	16.8%	17.1%
EV / EBITDA	8.4	10.5	9.8	10.6	11.4	10.4	8.9	7.8	6.7
EV / EBIT	20.6	14.2	13.0	13.6	14.6	13.7	11.6	9.9	8.4
Yield %	1.6%	1.2%	1.3%	1.2%	4.2%	1.8%	2.7%	2.3%	2.7%

\* historical datas are average figures  
source: Jefferies International Ltd.

## 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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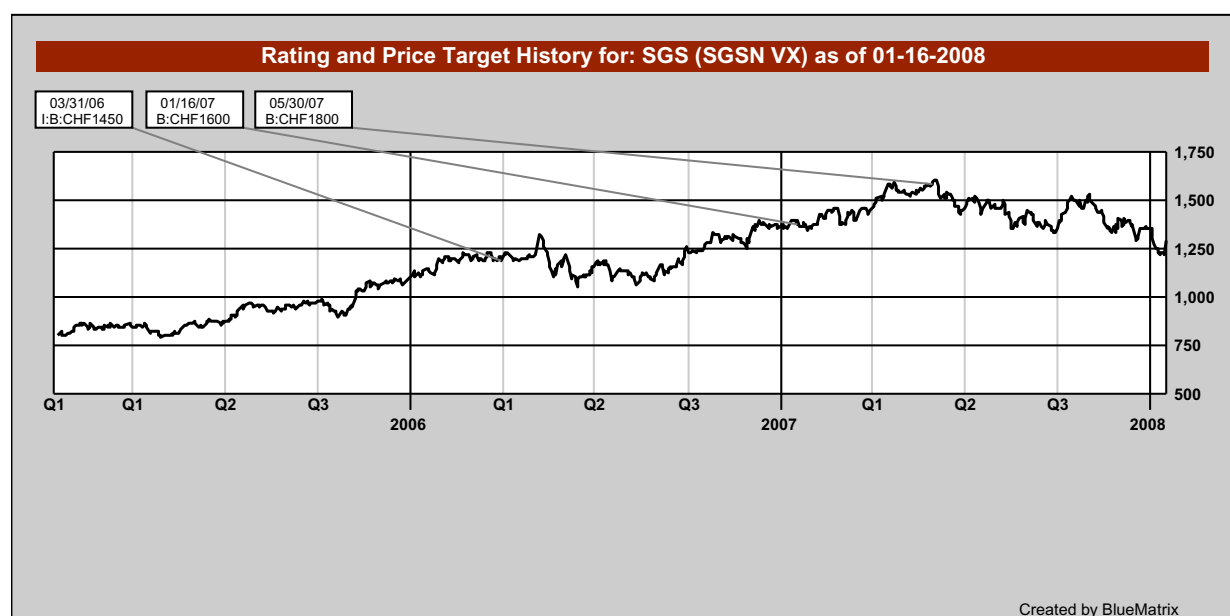
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Rating	Count	Percent	IB Serv./Past 12 Mos.	
			Count	Percent
BUY [BUY/ SB]	495	57.16	59	11.92
HOLD [HOLD]	351	40.53	29	8.26
SELL [SU/ UNPF]	20	2.31	3	15.00

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