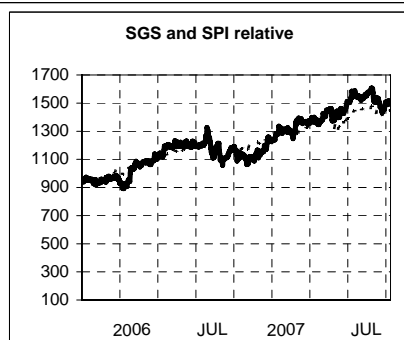


H1 2007 results

Top-line growth acceleration, strong acquisition pipeline → BUY confirmed, unchanged price target of CHF 1,750

BUY

Market cap.	CHF m	11513	Key figures	2005	2006	2007E	2008E	2009E	CAGR
Last price	CHF	1'511	(CHF)						04-09E
52 week high	CHF	1628	Net revenues (m)	3308	3821	4459	5139	5640	14.3
52 week low	CHF	1063	Growth rate (%)	14.7	15.5	16.7	15.3	9.7	
YTD performance	%	11.3	EBITDA (m)	642	777	925	1'078	1'205	18.9
Economic value	CHF	1793	Margin (%)	19.4	20.3	20.7	21.0	21.4	
Soft factor ded.	%	0.0	EBIT (m)	502	605	731	873	985	21.2
Fair value NZB	CHF	1793	Margin (%)	15.2	15.8	16.4	17.0	17.5	
Div. ranking shs	m	7.6	Net profit (m)	371	443	526	629	706	20.5
Symbols	SGSN.VX, SGSN VX		Dividend	50.0	20.0	25.0	30.0	34.0	23.2



EPS revision	2005	2006	2007E	2008E	2009E	CAGR
EPS new	49.4	58.1	69.0	82.6	92.7	20.1
EPS old			69.1	82.5	92.7	
% change			-0.1	0.1	0.0	

Valuation (x)	2005	2006	2007E	2008E	2009E
P / E	19.2	20.9	21.9	18.3	16.3
P / CEPS	19.2	20.9	21.9	18.3	16.3
P / BV	5.0	6.0	6.0	4.9	4.1
EV / EBITDA	12.4	13.1	12.2	10.5	9.0
Dividend yield (%)	5.3	1.6	1.9	2.2	2.5

SGS was able to achieve a record organic growth rate of 11.5% in the first half, with an outstanding performance in the Industrial Services division. The group's operating margin increased 30bp year-on-year to 15.5%, slightly below expectations, with only three divisions improving their margins. The slight disappointment was attributable to, among other things, some seasonal effects, restructuring costs, a dilutive impact from disposals and higher management stock option compensation. The management stated that the acquisition pipeline was full with more than 40 large to small interesting targets and that acquisition activity should accelerate in H2 2007. SGS' 2008 targets were reaffirmed and a buoyant outlook was issued for the second half.

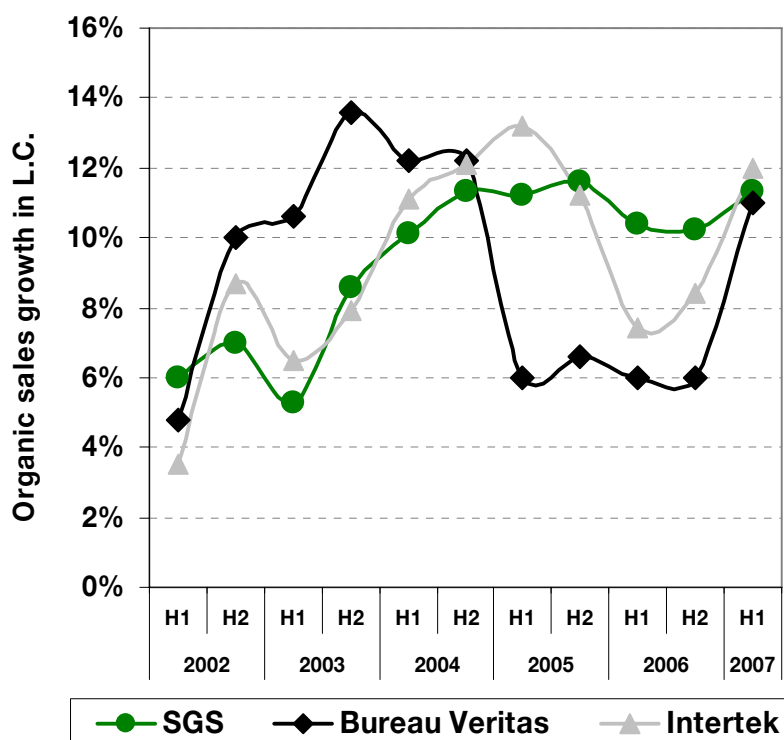
BUY rating maintained with a price target of CHF 1,750

Based on our new estimates, we derive a new fair value NZB of CHF 1,793 per share (vs. CHF 1,788 previously).

The acceleration of the organic sales growth despite the sharp slowdown in Consumer Testing Services was impressive. Although the 30bp margin improvement may look meager, we believe it is at most a temporary slowdown. SGS is a growth company, and the business should consequently be managed and driven toward growth as opposed to trying to reach a rigid operating margin target at any price. Therefore, the acceleration of the top-line growth in H1 2007 and the promising business pipeline, confirm our investment case on SGS. Finally, after a rather quiet first half in terms of acquisitions, we believe that the process is likely to accelerate in the coming months. We are therefore reiterating our BUY rating, with an unchanged price target of CHF 1,750.

- **Record organic growth rate in H1 07:** Fueled by continued demand in the commodities markets, sustained levels of international trade, prior-period investments in new business initiatives and further expansion in new geographical areas, SGS was able to achieve a record organic growth rate of 11.5% in the first half. Without exception, all ten divisions achieved positive growth, with the Industrial Services division posting an organic growth rate of nearly 20%. Six out of ten business units reported organic growth in excess of 10%. The GIS division returned to positive (double-digit) growth after last year's sales decline due to the discontinuation of contracts in Venezuela and Nigeria.

Acceleration of organic growth rates



Source: Company data, NZZ Neue Zürcher Bank estimates

This strong overall result was additionally bolstered by acquisitions net of divestitures (+0.3%, 1.7% from acquisitions, -1.4% from disposals) and a positive currency effect (+1.4%). The expected small impact of acquisitions was a disappointment for the market because SGS' stated aim is to have acquisitions boost consolidated revenue by 5% per annum. So far this year the group has made only three minor acquisitions (see below).

SGS' 15.3% increase in operating profit to CHF 324m was again robust, though the market was expecting more. The operating profit margin improved by 30bp to 15.5%, slightly below our expectation. The overall increase in operating profit was aided primarily by strong volume growth (operational leverage), an improvement in the business mix toward more upstream services and synergies from past acquisitions. The operating result was also positively impacted by the currency effect.

Surprisingly, and this is rather unusual at SGS, only three divisions (among them two of the biggest) were able to improve their operating

margins while the others saw a deterioration, which we did not really expect.

The Oil, Gas & Chemical Services division boosted its margin by 120bp to 15.0%, Industrial Services by 260bp to 15.7% and Government and Institutions by 40bp to 14.0%.

By contrast, three divisions reported very disappointing margin developments: Life Science Services, Consumer Testing Services (after margin gains in eight consecutive semesters) and Systems & Services Certification. However, the margin deteriorations are explainable. In the Life Science Services division, soft market conditions in France as a result of the European clinical trial directive, reduced quality-control volumes in the Benelux countries and longer-than-expected startup periods for the division's greenfield labs in Asia adversely affected operating earnings. Nonetheless, although these explanations make sense, the overall result remains weak because the group has never succeeded in achieving a strong result in that division. SGS is still far away from the targets set back in 2004 calling for sales of CHF 400m and a margin of 20% for that division. The management change at the start of July is a clear sign in our view that the top management wants a clear turnaround in Life Science Services division. CEO Chris Kirk is expecting first results by the end of this year.

The situation is a bit different in the Consumer Testing Services division, which suffered from a high comparison base. Last year, the division benefited from the introduction of RoHS (Restriction of Hazardous Substances) tests (more than 80,000 in China alone), a highly profitable business. According to the management, stripping out RoHS, the division's performance was more than satisfying (both at the top-line and operating profit level).

Finally, the Systems & Services Certification division is currently going through the last year of a three-year audit cycle for accreditation of compliance with ISO 9000 standards. In addition, the division incurred costs for personnel training and product positioning that should then disappear in the second half.

Net income excluding exceptional items rose 17.0% to CHF 234m. The tax rate of 25.0% was in line with the management's guidance and our expectation. Minority interests of CHF 9m were lower than last year (CHF 13m), which can probably be attributed to the CTS business in China (booming RoHS last year), where SGS operates through SGS CSTC Standards Technical Services (in which SGS holds a 65% stake).

Cash flow increased 7.5% to CHF 230m. DSO (days sales outstanding) was flat year-on-year. However, the underlying trend remains very positive according to CFO Rich Tobin. The reason why DSO was not reduced is that the European business had strong growth in H1 2007 with a 12% sales increase. In that region the payment terms are longer.

Capex amounted to CHF 124m, or 6% of sales, in line with the guidance for the FY. Around two-thirds of the capex was allocated to growth initiatives, with the rest earmarked for maintenance. More than a fifth of the capex was given to the Consumer Testing Services division in order to expand and improve its lab network. We also noted further investments in the booming Oil, Gas & Chemicals division as well as in Minerals (six new geochemistry labs in Africa and eastern Europe).

- **More than 40 targets in the pipeline:** So far this year SGS has announced two small acquisitions that do not even represent 1% of group sales. However, they were strategically important because they enabled SGS to enter the regulated grain inspection sector in North America. Yesterday the group announced a third acquisition, Cota Spa, the market leader in Vehicle Inspection Services in Algeria. In addition, the group also announced a new car testing project in Morocco (operational in 2008) in cooperation with a partner.

This low M&A activity may appear disappointing since one of the main missions assigned to new CEO Chris Kirk, who replaced Dan Kerpelman at the end of last year, was to accelerate the acquisition pace. However, Chris remains very confident about making acquisitions in H2 2007. More than 40 acquisitions are currently in the pipeline, a higher number than in the past, he says. This pipeline ranges from very large to smaller, strategic companies operating in a niche.

In the context of large acquisitions, two statements from the management are important in our view: 1) SGS is not in negotiations with Bureau Veritas, which is owned by Wendel Investissement, which recently announced that it was taking Bureau Veritas public. However, the CEO also stated that SGS continues to 'like' Bureau Veritas, thus implying that it has not given up on merging with the French competitor; 2) the group stated that the Water business is something very interesting for the future and that three or four attractive players are on its watch list; this kind of transaction would create a new division, as would have been the case if SGS had been able to acquire Germanischer Lloyd last year.

- **Not overly concerned by the low acquisition activity:** As we mentioned in a recent report, we believe that concerns about acquisitions should not be exaggerated. We recall our main arguments:
 1. Management reiterated that it would continue to apply strict rules (price and timeframe for the payback, strategic fit, management, risk profile, unique technology, etc.) in the acquisitions process. The main objective is the 'race to create value' rather than make bolt-on acquisition merely to boost sales. The newly acquired companies should create value and offer something to SGS' network of service offerings (such as last year's acquisition of SRS, a company in South Korea present in a small but booming niche).
 2. From past experience, SGS' sparseness in closing deals in the last few months doesn't mean that it won't be active in the second half of the year. In June, for instance, Intertek announced three acquisitions within three days, and Bureau Veritas last year announced four acquisitions within three weeks. Yesterday, CEO Chris Kirk agreed with that and said he would not be surprised to see SGS make five more acquisitions in the second half to reach seven or eight acquisitions for 2007, as was the case in 2006.
 3. We believe that the 5% external growth target should be tracked on average per year through 2008 rather than on a yearly absolute figure. Furthermore, the group has grown organically in the past three halves by more than 10%, which should definitely help toward the CHF 5bn sales target.
- **Confirmation of 2008 targets, slight adjustments to NZZ estimates:** SGS remains confident about achieving the targets set for 2008 (CHF 5bn in sales, 17% operating margin, EPS of CHF 80). In

addition, the management gave some indications for the current year, hinting that the 2007 performance is expected to be consistent with the achievement of the 2008 objectives. From our discussions with the management, we believe that the group's operating margin should significantly improve in the second half.

In view of the H1 results and the management's comments, we have adjusted our estimates mainly to reflect the different development of the ten divisions. Overall, our changes have had only a marginal impact on our EPS forecasts because the H1 figures were in line with our estimates. We recall that our estimates include future acquisitions in order to get to the 2008 targets.

- **Valuation:** On our modified estimates, we now derive a new 'fair value NZZ' – based on EVA[®]/DCF models – of CHF 1,793 per share (vs. CHF 1,788 previously).

Based on our new estimates, SGS is trading at a P/E 08E of 18.3x and an EV/EBITDA 08E of 10.5x. This valuation is in line with SGS' competitor Intertek, as the gap has closed in the past weeks. We still consider a premium of at least 10% versus Intertek justifiable given SGS' superior business mix (lower risk profile), its increasing market share in Consumer Testing and in Oil, Gas and Chemicals Services, its higher operating leverage and its sound financial situation.

Valuation Comparison

Company	Currency	Share price	Market cap in m in local curr.	P/E 2007E	P/E 2008E	EV/EBITDA 2007E	EV/EBITDA 2008E
SGS	CHF	1,511	11,513	21.9x	18.3x	12.2x	10.5x
Intertek Group	GBP	1.030	1,598	21.1x	18.5x	12.1x	10.5x

Source: NZZ Neue Zürcher Bank estimates, JCF

- **Opinion and recommendation:** The acceleration of the organic sales growth despite the sharp slowdown in Consumer Testing Services was impressive. Although the 30bp margin improvement may look meager, we believe it is at most a temporary slowdown and that the group is on track to reach an overall margin of 17% by 2008. SGS is a growth company, and the business should consequently be managed and driven toward growth as opposed to trying to reach a rigid operating margin target at any price. Therefore, the acceleration of the top-line growth in H1 2007 and the promising business pipeline, which should further accelerate the organic growth rate and also drive further margin improvement in H2 2007, confirm our investment case on SGS. Finally, after a rather quiet first half in terms of acquisitions, we believe that the process is likely to accelerate in the coming months, which should trigger further moves in the share price. We are therefore reiterating our BUY rating, with an unchanged price target of CHF 1,750.

Agenda:

– January 2008

FY 2007 results

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