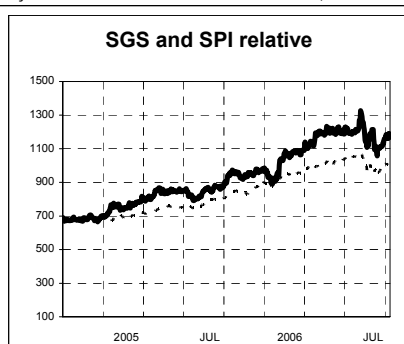


## H1 2006 results

‘Performing is an ongoing attitude’, TAS  
excluded – BUY maintained, PT CHF 1350

## BUY

<b>Market cap.</b>	<b>CHF m</b>	<b>8166</b>
Last price	CHF	1'088
52 week high	CHF	1349
52 week low	CHF	887
YTD performance	%	-1.8
<b>Economic value</b>	<b>CHF</b>	<b>1341</b>
Soft factor ded.	%	0.0
<b>Fair value NZB</b>	<b>CHF</b>	<b>1341</b>
Div. ranking shs	m	7.5
Symbols	SGSN.VX, SGSN VX	



Key figures (CHF)	2004	2005	2006E	2007E	2008E	CAGR 02-08E
Net revenues (m)	2885	3308	3821	4214	4620	13.5
Growth rate (%)	17.6	14.7	15.5	10.3	9.6	
EBITDA (m)	508	642	762	857	958	19.3
Margin (%)	17.6	19.4	19.9	20.3	20.7	
EBIT (m)	377	502	601	686	777	21.8
Margin (%)	13.1	15.2	15.7	16.3	16.8	
Net profit (m)	278	371	449	492	559	19.7
Dividend	12.0	50.0	18.0	20.0	23.0	20.6

EPS revision	2004	2005	2006E	2007E	2008E	CAGR
EPS new	37.0	49.4	59.9	65.5	74.4	20.2
EPS old			58.4	66.9	76.2	
% change			2.5	-2.1	-2.3	

Valuation (x)	2004	2005	2006E	2007E	2008E
P / E	19.4	19.2	18.2	16.6	14.6
P / CEPS	18.3	19.2	18.2	16.6	14.6
P / BV	4.6	5.0	5.3	4.3	3.5
EV / EBITDA	11.1	12.4	10.6	9.1	7.7
Dividend yield (%)	1.7	5.3	1.6	1.8	2.1

For the first time in the past few semesters, SGS was unable to give the market a positive surprise with its half-year results. This was mainly due to the sharply negative impact of the discontinuation of two contracts in the TAS division, which was clearly underestimated by investors. The outstanding results (organic growth of nearly 14%, significant margin improvement, both excluding TAS) in the core divisions were completely overshadowed by the sluggish development of TAS. With regard to the H1 2006 figures, we believe that the company is on track to achieve its targets for 2008, which were confirmed by management. The latter also stated that the acquisitions pipeline was full, so that we can (finally) expect to see an acceleration of external growth.

**BUY rating maintained with a price target of CHF 1,350**

Based on our new estimates (fine-tuning, minor changes overall), we have now derived a new fair value NZB of CHF 1,341 per share, which leaves a significant upside of more than 20% for the stock.

It can be argued that since TAS is part of the SGS group, it is inappropriate to ‘neutralize’ the negative impact outlined above. In our view, however, the discontinuation of the two big contracts has significantly reduced the division’s exposure to traditional PSI activities, thus also decreasing the volatility of the group’s sales development. We believe that excluding the TAS division when tracking SGS provides a more accurate picture of the strength of the business. We also believe that the new strategic initiatives combined with the potential of the current portfolio and possible future acquisitions continue to offer exciting prospects. Therefore, we definitely consider yesterday’s share weakness as exaggerated, and as offering a clear buying opportunity. Consequently, we have no hesitation in reiterating our BUY rating with an unchanged price target of CHF 1,350.

- **Excluding TAS, organic sales growth accelerated to 13.7% and margin jump of 80bp to 15.3% in H1 2006:** Thanks to new geographical areas entering the commodities supply chain, as well as new laboratory outsourcing contracts and the deployment of new products, SGS reported a strong first semester in 2006 except for the Trade Assurance Services (TAS) division. Overall, sales grew by 18.5%. Organic sales growth amounted to 10.4%. However, if we consider the group result excluding the TAS division, organic growth would have been 13.7% according to our calculations (14.0% according to company), thus accelerating from the 13.4% seen in both H1 and H2 2005. This compares to Intertek's organic growth of around 6% and 9%-10% (excluding its FTS division – similar to TAS) respectively.

Five out of ten business units reported organic growth in excess of 10%. The division TAS reported a sales decrease of above 30%, mainly due to the discontinuation of contracts in Venezuela and Nigeria (both valued at around CHF 80m on a yearly basis). However, the non-PSI (Pre Shipment Inspection) business achieved a stunning 60% growth result, according to management. We find it difficult to understand the sharp drop in overall TAS sales, as the company communicated earlier that non-PSI activities made up around 30%-40% of the TAS division. We hope that management will provide more details in the near future, and that the reporting transparency with respect to this division will increase, given the negative surprise created by the latter's results.

Acquisitions net of disposals accounted for CHF 69m of sales at group level, or a positive impact of 4.3%, while foreign currencies had a positive impact of 3.8%.

The group's 19.6% increase in operating profit to CHF 281m was still impressive, in spite of the significant negative impact of the TAS division. The operating profit margin improved by 20bp to 15.3% in line with our expectations. Excluding the TAS division (margin down 800bp to 13.7%), however, the margin improvement jumped by 80bp from 14.5% to 15.3%, a very solid result (NZZ calculations). The overall increase in operating profit was aided primarily by strong volume growth (operational leverage), improvement in the business mix towards more upstream services, as well as by synergies from past acquisitions.

#### H1 2006: an overview of the divisions

	A	B	C	D	Comments
Agricultural Services	8.5	9.3	11.9	76	New services based on OGC and Minerals model
Mineral Services	12.2	18.1	16.7	132	8 new laboratories in geochemistry in 4 continents
Oil, Gas & Chemical Services	20.3	13.4	13.9	88	Strong growth in LNG, as well as in oil activities
Consumer Services	15.3	32.3	22.8	113	Capacity added in chemicals, electronics testing
Systems & Services Certification	8.2	16.1	18.3	223	The winning division of the Group!
Automotive Services	6.0	3.3	13.7	16	Statutory vehicle inspection: 60% of the business
Industrial Services	13.0	11.8	13.1	-2	Restructuring in NA, start up costs in Asia
Life Science Services	5.1	-1.8	12.1	-207	Will sustainable organic growth ever come?
Environmental Services	6.8	6.9	9.0	-97	Sluggish days are back, eternal turnaround
Trade Assurance Services	4.6	-30.9	13.7	-799	Venezuela and Nigeria, but non-PSI growth 60%
<b>Total Group</b>	<b>100</b>	<b>10.4</b>	<b>15.3</b>	<b>16</b>	<b>Excl. TAS, 13.7% org. growth, 80bp margin jump</b>

A: Sales in % of group sales

B: organic sales growth in %

C: Operating margin in %

D: Operating margin improvement in bps

Source: company data, NZZ Neue Zürcher Bank estimates

The margin improvement was especially significant in the Mineral Services, Consumer Testing Services and Systems & Services

Certification Services. The latter reported an impressive operating margin of more than 18%. This is even more exceptional, given that this division operates on a very light asset base. By contrast, Life Science Services also notched up very disappointing margins (restructuring costs mainly on aster-cephac, lab start up costs, etc.), as did the Environmental Services division (weather-related issues as well as home made problems). Finally, for the first time, the margin of the acquired companies stood below group average at 14.1%.

SGS reported CHF 21m net income for exceptional items: CHF 36m net gain on changes in the group's organization (disposals) minus CHF 6m in legal and warranty claims and minus CHF 9m restructuring costs.

Net income including exceptional items was up 23.6% to CHF 215m. Both the financial result (lower than last year due to a lower cash position because of the exceptional payment to shareholders in H1 06) and the tax rate were in line with our forecasts. Minority interests of CHF 13m were higher than expected (CHF 9m). We believe that this increase from CHF 8m last year can be mainly attributed to the booming business in China in CTS, where SGS operates through SGS CSTC Standards Technical Services (65% stake from SGS).

Cash flow was up CHF 74m to CHF 214m: the development of working capital has improved compared to prior semesters. This is the direct consequence of management's increased focus on capital efficiency. DSO (Days Sales Outstanding) were down two days compared to last year.

CAPEX amounted to CHF 117m or 6.3% of sales (vs. 6.1% in H1 06 and 6.3% in H2 06), which is relatively high in comparison with that of the group's competitors. Around 60% of these CAPEX were allocated to growth initiatives, with the rest given to maintenance. Around a third of the CAPEX was awarded to the star performer amongst the divisions – Consumer Testing Services – in order to expand and improve its lab's network (Guangzhou) and infrastructure (E&E, lab in Korea). This represents an acceleration with regard to FY 2005, where only a quarter of the CAPEX was given to CTS. We also noted the CHF 11m investment in the TAS division, mainly to acquire seven new scanners for the non-PSI business. As often stated earlier, we believe that the increase in CAPEX in the past years was decisive for SGS' solid performance in the past semesters. The company's operating margins should continue to benefit from these investments in the coming years.

- **Still waiting for larger acquisitions:** In the first six months, SGS acquired four companies, namely aster.cephac and Northview Biosciences in Life Science Services, and Cotax and Laroute in OGC. These companies represent annual sales of around CHF 100m. We were surprised by the relatively high price paid for these acquisitions (CHF 190m, including CHF 131m goodwill). In the same period, SGS divested smaller, non-core activities (Pink Healthcare services, the Environmental business in Canada and an oenology laboratory in France) for a net cash inflow of CHF 51m.

We are somewhat disappointed by the acquisition rate of SGS, given that one of its 'Growth Strategy' pillars refers to 'Accelerated Growth', i.e. acquisitions (the 2008 targets include 5% top-line external growth). In the first semester, acquisitions amounted to only 4.4%, and this impact is expected to drop to 2.2% in H2 06 and 3.0% in FY 06 respectively. In other words, the company will need to announce

acquisition plans very soon in order to remain on track with its growth plan. During yesterday's presentation, management offered reassurance by announcing that its pipeline of interesting targets was full, and that the company had remained very active in screening the market for ideal partners. At the same time, management made it clear that it would continue to apply strict rules with regard to such a decision (price and timeframe for the payback, strategic fit, management, risk profile, unique technology, etc.).

- **Outlook 2006 and new NZZ estimates:** SGS provided a rather vague outlook for the rest of the year (the company will continue to improve its operating performance), and confirmed its 2008 targets (CHF 5bn sales, 17% operating margin, EPS of CHF 80). Management hinted that various projects had been launched, and that the strategic plan was on track.

On the back of the H1 2006 figures and outlook, we have updated our estimates for the different divisions for 2006ff (details in our financial model). We now expect organic sales growth of 10.8% in the current year (vs. 10.9% previously). However, excluding TAS, we have increased our forecasts with regard to organic growth (from 12.7% to 13.6%) in order to reflect the dynamics of the key divisions. All other assumptions remain largely valid (slightly lower operating margins in 2006ff). Overall, our estimate changes have had a positive impact on EPS 2006 of around 2.5% (exceptional items), but a minor negative one on 2007ff of 2% (higher minority interests).

#### New vs. old key figures (estimates)

In CHF m	FY 06E (old)	FY 06E (new)	FY 07E (old)	FY 07E (new)	FY 08E (old)	FY 08E (new)
Sales	3776	3821	4162	4214	4563	4620
Organic growth in %	10.9	10.8	10.6	10.6	9.6	9.6
Operating profit	598	601	686	686	775	777
Operating profit margin in %	15.9	15.7	16.5	16.3	17.0	16.8
Net profit	438	449	502	492	572	559
EPS in CHF	58.4	59.9	66.9	65.5	76.2	74.4

Source: company data, NZZ Neue Zürcher Bank estimates

- **Valuation:** Based on our new estimates, SGS is trading at a P/E 07E of 16.6x and an EV/EBITDA 07E of 9.1x. This valuation is at a premium (around 20%) to the group's competitor Intertek. We still consider a premium versus Intertek justifiable, given SGS' superior business mix, increasing market share in Consumer Testing and in Oil, Gas and Chemicals Services, its higher operating leverage and sound financial situation.

#### Valuation Comparison

Company	Currency	Share price	Market Cap in m in local curr.	P/E 2006E	P/E 2007E	EV/EBITDA 2006E	EV/EBITDA 2007E
SGS	CHF	1088	8166	18.2x	16.6x	10.6x	9.1x
Intertek Group	GBP	615	992	14.5x	12.8x	8.8x	7.6x

Source: NZZ Neue Zürcher Bank estimates, JCF

Based on our altered estimates, we have now derived a new fair value NZZ, based on EVA@/DCF models, of CHF 1,341 per share (vs. CHF 1,326, no deduction for insufficient soft factors), which leaves significant upside of more than 20% for the stock following the weakness in the past days. This fair value does not include future acquisitions.

We have also developed a financial model including future acquisitions which shows a fair value NZB of more than CHF 1,450 per share; this indicates the leverage potential in terms of acquisitions.

- **Opinion and recommendation:** Excluding the performance of the TAS division, we believe that SGS reported the highest organic sales growth ever, and made significant improvement in its margin development. One could argue that TAS is part of the group, and that it is inappropriate to 'neutralize' the division's negative impact. In our view, however, the discontinuation of the two big contracts in Venezuela and Nigeria will significantly reduce exposure to traditional PSI activities, thus decreasing the volatility in the group's sales development. The current President of the Board stated many times when he was CEO that the TAS division would not be actively pushed and was not management's main priority. Therefore, we believe that excluding TAS when tracking SGS (or FTS when tracking Intertek) provides a more accurate picture of the business' strength.

We believe that the new strategic initiatives and the potential of the current portfolio, as well as possible future acquisitions, still represent exciting prospects for the coming months, in spite of the temporary negative impact of the TAS division. We therefore view yesterday's share weakness as exaggerated, and as offering a clear buying opportunity. Consequently, we have no hesitation in reiterating our BUY rating with an unchanged price target of CHF 1,350.

- **Agenda:**
  - 15 January, 2007                      FY 2006 results
  - 19 March, 2007                        AGM

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