Services Group
Diversified Commercial

Switzerland

SGS (VX: SGSN VX)

Testing Times: H1 Growth Comes Up Short

Investment Summary

H1 results revealed numerous cracks in what had been a relatively cyclically resistant business. While we do so with some trepidation, we remain Buyers of what remains the premium name in a structurally compelling industry.

Company Update
Price Target Change
Estimate Change

Rating:	BUY
Price:	CHF1,235.00
Price Target:	CHF1,375.00
Previous:	*CHF1,400.00*
Bloomberg:	VX: SGSN VX

Market Data

52-Week Range:	CHF1,563.21-CHF872.46
Total Entprs. Value (MM):	CHF8,603.5
Market Cap. (MM):	CHF9,262.5
Shares Out. (MM):	7.5
Avg. Daily Vol.:	23,667

Financial Summary

Net Debt (MM):	(CHF659.0)
Net Debt/Capital:	(20.0%)
Dividend Yield:	4.0%

CHF	2007A	2008A	2009E	2010E
Rev. (MM)	4372.0	4818.0	4970.0	5348.0
Prev.	--	--	*5289.6*	*5737.8*
EV/Rev.	2.0x	1.8x	1.7x	1.6x
EBITDA (MM)	908.0	1,024.0	1,035.0	1,123.0
Prev.	--	--	*1,084.6*	*1,175.5*
EV/EBITDA	9.5x	8.4x	8.3x	7.7x
EPS				
FY Dec	**65.47**	**76.19**	**78.33**	**85.29**
Prev. FY	--	--	*80.52*	*87.89*
FY P/E	18.9x	16.2x	15.8x	14.5x
EBIT (MM)	690.0	809.8	812.0	889.0
Prev.	--	--	*862.9*	*930.3*
EV/EBIT	12.5x	10.6x	10.6x	9.7x
Net Profit	500.0	579.0	578.0	639.0
Prev.	--	--	*611.7*	*667.7*

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Event

SGS reported H1 results and held an analyst meeting.

Key Points

- **Growth comes up short.** Despite solid mid-term figures from BV (BVI FP, €33.23, Hold) and ITRK (ITRK LN, 1058p, Hold)and reassuring signs from management during their March AGM, H1 growth underwhelmed. Sales over the half year were CHF2.33b vs. our CHF2.49b estimate, with organic growth of 4% (vs. our 6%) accounting for 1/3 of the miss, and the remainder due to our poor currency forecast. Negative surprises came from the Consumer business, where SGS did not fully capitalize on the CPSIA opportunity; the Minerals division, which bore the brunt of falling trade volumes and exploration budgets; and the Industrials division, which was hit by weak construction demand. Sequentially each of SGS's 10 businesses saw growth decelerate.
- **Margin on track.** While sales missed our target, margin performance was strong, increasing 10bps y/y to 16.2%. Margins improved y/y in 6 of 10 divisions, with key positive surprises in the Consumer division (+300bps) which benefited from good throughput and mix, and in the SSC, Agriculture and GIS divisions.
- Net profit of CHF255m was well shy of our CHF283 forecast due to the (largely forex driven) sales miss and a CHF15m restructuring charge which concentrated on the Minerals business (37% of the total charge).
- **Where do we go from here?** While management reiterated their growth targets (<10% LFL growth and stable margins) and suggested H2 growth could match H1, we expect H2 to mark a further deceleration in growth as the Consumer division runs into tough comps, the Minerals, Chemicals and Automotive businesses remain weak, and the Oil & Gas and Industrial services divisions grow marginally. Adjusting for that more negative outlook, we have pulled down our FY LFL estimate to 3.6% from 5.2%, but we have slightly increased our margin forecast given the good resilience shown in H1.

Valuation/Risks

We continue to value SGS by applying a mid-cycle multiple (17.5x) to our forward EPS estimate. The resulting target price is CHF1,375. That value is supported by our CHF1,520 DCF value. Key risks include a slower than expected recovery in the cyclical businesses including Minerals, Chemicals and Automotive.

Impact on Other Companies

Read across to BV and ITRK is mixed. While we believe both could post better than expected Consumer division margins, SGS's weakness in Minerals and Construction augurs very poorly for BV's Q2.

- The **Agricultural Services** division was the positive highlight of the results, with growth of 10.2% LFL vs. our 10% forecast and 270bps margin improvement vs. our 100bps forecast. The solid growth was driven by a good global harvest and the continued growth in inland services. The business was also aided by a relatively easy comparable period as H1'08 was hit by export restrictions in a number of key markets. Margin improvement was driven by better mix related to strong inland service business, and by healthy volumes and capacity utilization.
- Looking forward, the company pointed to improving markets in Asia in H2 as falling export restrictions boost trade and new inland projects take hold, but also noted potential slowing in the Black Sea region in H2 due to export restrictions. We are modelling slightly slower 8% LFL growth in H2 given the tough comparable period.

- **Minerals Services** was the laggard in H1, contracting by 9.1% LFL vs. our 0% forecast, while margins dropped 520bps vs. our -150bps forecast. As expected, the business was hit both by slowing trade volumes and by curtailed exploration and production activity in base metals. The only bright spots were process work at on-site labs which remained stable, and coal and gold related business where demand was strong.
- Management pointed to a troughing in trade volumes in Q2/Q3 as inventory drawdowns slow, but does not expect a rebound in the trade business until 2010. Similarly, the base metal related exploration business has seen some signs of life with improved financing conditions, but we would not expect that to translate into a recovery until at least 2010. Taken together, we do not expect a material recovery in the minerals business until 2010, and expect H2 to be similar to H1. Despite depressed demand we would expect slightly better margin performance in H2 given the cost cutting carried out in the first half.

- **Oil, Gas & Chemical** recorded an in-line half, growing 1.9% (vs. our 4% forecast), with a flat margin y/y. While the core cargo business and upstream oil & gas business performed well, the division was hurt by significant weakness in the chemicals related activities (roughly 10% of turnover). Looking ahead, we would not expect an improvement in chemicals until 2010 (the business lags industrial production trends) and are forecasting flattish performance in both the trade related and upstream businesses. News on the renewal of the Indian kerosene project, which is in the process of being re-tendered, could provide some upside.

- The **Life Science** business reported a reasonable result given the state of the global CRO industry. LFL growth of 7.5% beat our 5% forecast as quality control demand continued to grow – particularly in Asia as new capacity came on line. In keeping with global trends, clinical trial work was slower due to funding challenges in the biotech industry and a 'wait and see' pharma approach to spending. Management did note that Q2 growth accounted for the vast majority of H1 expansion after a roughly flat Q1 – highlighting the improved market environment.
- Looking forward we expect the division to continue to benefit from new capacity and expect a gradual improvement in clinical trial work as the funding picture improves.

- In contrast to BV and Intertek, SGS seems to have missed the boat on the CPSIA related consumer testing boom. H1 **Consumer** LFL growth of 12.2% was well shy of the organic growth posted by BV (+38% in Q1) and ITRK (+18% through April) – although both BV and ITRK are expected to show slowing growth in Q2. Offsetting some of the disappointment on turnover was the 300bps margin expansion - well ahead of our +30bps forecast (which was based on BV's Q1 commentary indicating stable pricing). The solid margin improvement was attributed to good volume leverage and business mix – both of which should also be apparent in BV and ITRK's results when they report in August.
- Looking ahead into H2, we expect weak inspection volumes and tougher comps to lead to falling growth rates. While management highlighted a potential catalyst in the expansion of the CPSIA program beyond toys and textiles, we see no hints of such a change in the near term.

- **Systems & Certification** was its typical steady self, growing 5.3% LFL (vs. our 7% forecast) and expanding margin by 110bps vs. our forecast for flat profitability. Growth was driven by emerging markets which enabled the division to overcome weakness in traditional audit markets where SGS is seeing some pricing pressure.
- While we do not expect pricing pressure to abate, H2 should benefit from the traditional 3 year ISO9000 renewal cycle. As such, we are forecasting a slight acceleration in LFL growth (to 7%) in H2 and a 50bps margin improvement for the full year.

- **Industrial Services** reported a tough quarter, with LFL growth of 5.1% (vs. our 8% forecast) and 80bps margin erosion (vs. our 0% forecast). Growth in the division came from emerging markets, power generation (particularly in alternative energy) and, counter intuitively, from good demand in chemicals and refining, where weak demand led to exceptional outages and maintenance work. Weak spots in the division were in construction and general infrastructure – which could be a source of concern for Bureau Veritas given its heavier weighting towards those end markets.
- For the remainder of the year we expect continued slow growth as infrastructure markets are expected to remain tough and power generation slows.

- **Environmental Services** recorded an encouraging half – despite our fears of a slowdown similar to that seen by

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BV in Q1. H1 LFL growth of 4.7% was in line with our 5% forecast. The result was driven by good performance in emerging markets and in climate change related businesses. Those healthy markets contrasted with tougher conditions in North America and Western Europe where the business is more heavily exposed to soil testing and construction trends.

- For the remainder of 2009 we are forecasting marginal growth as soil testing in particular is unlikely to rebound given construction exposure.

- The **Automotive Services** division managed to eke out a flat result (vs. our -5% LFL forecast) despite significant headwinds. As expected, OEM related business (roughly 25% of turnover) was very weak. At the same time, the division could not replace the Irish driver testing business booked last year. On the positive side, the statutory business (roughly 75% of turnover) remained stable and new contracts (New Jersey, Massachusetts) are slowly ramping up.
- While the OEM market is nowhere near healthy, we would expect H2 to be a bit stronger than H1 as global automobile production slowly comes back on line after numerous outages. Nonetheless, H2 is expected to be much of the same, with OEM business down significantly and tough Irish comps. Our 2010 forecasts are slightly more optimistic as the OEM segment comes back to life.

- The **Governments & Institutions Services** (GIS) division performed extremely well in H1, with LFL growth of 10% (vs. our 6% forecast) and margin expansion of 170bps vs. our +10bps forecast. Growth again came from scanners and customs enhancement services, while the PSI business remained stable. Margins in the division benefited from good capacity utilization as scanner projects came on stream.
- For the remainder of '09 we expect continued steady expansion given more limited exposure to global growth trends in many of the division's target markets.

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SGS Results Analysis

Total	H1 '08 Actual	H1 '09 Actual	H1 '09 Jefco Est.
Revenues	2,298	2,327	2,490
% Growth	10.0%	1.3%	8.4%
LFL Growth (%)	*15.0%*	*4.1%*	*6.1%*
Perimeter Effect (%)	*2.0%*	*1.9%*	*1.8%*
Currency Impact (%)	*-7.0%*	*-4.7%*	*0.4%*
Operating Profit	370.2	376.0	398.5
Operating Margin	16.1%	16.2%	16.0%
Net Profit	**264.9**	**255.0**	**282.7**
EPS	**34.71**	**33.98**	**37.22**

	H1 '08 Actual	H1 '09 Actual	H1 '09 Jefco Est.	Comment
Agricultural Services				
Sales	167.4	176.3	183.3	Very strong global agricultural production season and easy comp overcome issues related to trade finance. Margin improves due to solid volumes and push into inland services. Guidance for strong H2 - we have pencilled in slight deceleration.
LFL Growth (%)	*6.0%*	*10.3%*	*10.0%*	
Operating Profit	21.7	27.7	25.7	
Operating Margin	*13.0%*	*15.7%*	*14.0%*	
Minerals Services				
Sales	320.8	261.5	327.0	Both trade volumes and exploration work slow significantly. On site production related labs more stable. Expect shipment related business to bottom in Q2-Q3, but return to healthy growth not expected until 2010.
LFL Growth (%)	*30.8%*	*-9.1%*	*0.0%*	
Operating Profit	63.5	37.0	58.2	
Operating Margin	*19.8%*	*14.1%*	*17.8%*	
Oil, Gas & Chemical Services				
Sales	455.8	468.6	490.5	Chemical business weak, but offset by trade facilitation and upstream services. Expect chemicals to improve in H2 (with industrial demand), but not grow until 2010. Energy related businesses expected to be stable.
LFL Growth (%)	*10.8%*	*1.9%*	*4.0%*	
Operating Profit	63.8	67.1	68.7	
Operating Margin	*14.0%*	*14.3%*	*14.0%*	
Life Sciences Services				
Sales	99.2	101.0	102.2	Clinical trial related work patchy. QC work very strong on back of new Asian capacity. Growth comes entirely from Q2. Less volatility expected going forward - but we note Jefferies U.S. CRO team view that pick-up in overall demand in the sector will be slow.
LFL Growth (%)	*6.6%*	*7.5%*	*5.0%*	
Operating Profit	11.2	10.7	12.3	
Operating Margin	*11.3%*	*10.6%*	*12.0%*	
Consumer Testing Services				
Sales	342.6	391.2	413.3	CPSIA impact less evident than for ITRK and BV. Margins leverage healthy volumes. H2 expected to be driven again by CPSIA, but uncertainty regarding end market demand heading into Christmas.
LFL Growth (%)	*17.9%*	*12.2%*	*16.0%*	
Operating Profit	76.7	99.2	93.8	
Operating Margin	*22.4%*	*25.4%*	*22.7%*	
Systems & Services Certification				
Sales	173.8	175.7	187.7	Weak traditional certification work offset by growth in emerging markets. Margins improve on higher service mix. Some pricing pressure seen on more routine certification work.
LFL Growth (%)	*8.2%*	*5.3%*	*7.0%*	
Operating Profit	31.3	33.6	33.8	
Operating Margin	*18.0%*	*19.1%*	*18.0%*	
Industrial Services				
Sales	352.4	371.3	397.4	Growth driven by emerging markets, power generation and exceptional refinery and chemicals outage work. Construction and general infrastructure markets weak.
LFL Growth (%)	*16.8%*	*5.1%*	*8.0%*	
Operating Profit	49.6	49.4	55.9	
Operating Margin	*14.1%*	*13.3%*	*14.1%*	
Environmental Services				
Sales	143.0	140.2	147.8	Weaker conditions in North America and Europe offset by healthy emerging markets.
LFL Growth (%)	*9.6%*	*4.7%*	*5.0%*	
Operating Profit	12.7	13.5	13.3	
Operating Margin	*8.9%*	*9.6%*	*9.0%*	
Automotive Services				
Sales	144.5	138.5	138.7	Very weak OEM business and tough comp due to one-off Irish business. Statutory business (~75% of revenue) remained solid. Margins hurt by lower driver testing revenues.
LFL Growth (%)	*23.6%*	*0.2%*	*-5.0%*	
Operating Profit	24.3	20.0	20.8	
Operating Margin	*16.8%*	*14.4%*	*15.0%*	
Trade Assurance Services				
Sales	98.2	103.1	102.1	PSI work stable. Scanners and customs enhancement programs growing. Margins improve due to good capacity utilization.
LFL Growth (%)	*10.0%*	*10.0%*	*6.0%*	
Operating Profit	15.4	17.9	16.1	
Operating Margin	*15.7%*	*17.4%*	*15.8%*	

Source: Company data and Jefferies Research

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December year end	2002	2003	2004	2005	2006	2007	2008	2009E	2010E	2011E
Income Statement (CHFm)										
Turnover	2392.0	2454.0	2885.0	3308.0	3821.0	4372.0	4818.0	4970.5	5347.7	5966.8
% change	2.6%	2.6%	17.6%	14.7%	15.5%	14.4%	10.2%	3.2%	7.6%	11.6%
EBITDA	311.0	396.0	508.0	642.0	800.0	908.0	1024.0	1035.1	1123.3	1258.9
margin %	13.0%	16.1%	17.6%	19.4%	20.9%	20.8%	21.3%	20.8%	21.0%	21.1%
EBIT	127.0	293.0	380.0	502.0	623.8	690.0	937.0	812.0	888.6	1005.7
margin %	5.3%	11.9%	13.2%	15.2%	16.3%	15.8%	19.4%	16.3%	16.6%	16.9%
Pre-Tax	140.0	303.0	386.0	507.0	622.8	692.0	933.0	808.0	892.8	1015.8
Net income	109.0	227.0	278.0	371.0	442.8	500.0	692.0	578.3	639.1	725.2
margin %	4.6%	9.3%	9.6%	11.2%	11.6%	11.4%	14.4%	11.6%	11.9%	12.2%
Balance Sheet (CHFm)	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009E**	**2010E**	**2011E**
Working Capital	216.0	196.0	139.0	223.0	252.0	256.0	274.0	287.4	309.2	345.0
WC as a % of turnover	9.0%	8.0%	4.8%	6.7%	6.6%	5.9%	5.7%	5.8%	5.8%	5.8%
Capital Employed	1263.0	1332.0	1497.0	1943.0	1747.0	2160.0	2331.0	2511.9	2972.1	3503.7
Net Debt	-402.0	-493.0	-438.0	-430.0	18.0	-201.0	-21.0	-658.8	-955.8	-1170.3
Gearing	-44.8%	-46.0%	-37.7%	-29.9%	1.2%	-10.4%	-1.2%	-30.9%	-37.3%	-38.2%
Cash Flow (CHFm)	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009E**	**2010E**	**2011E**
Cash Flow	219.0	395.0	486.0	598.0	582.8	694.0	802.0	900.4	900.2	1008.5
Capex	-121.0	-171.0	-201.0	-205.0	-224.0	-271.0	-278.0	-202.7	-267.4	-358.0
WCR	32.0	-70.0	-61.0	-187.0	-31.0	12.0	-22.0	-6.4	-21.8	-35.8
Free-Cash Flow	130.0	154.0	224.0	206.0	327.8	435.0	502.0	691.3	611.1	614.7
Key Valuation Ratios	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009E**	**2010E**	**2011E**
Shares Outstanding (m)	7.8	7.7	7.5	7.6	7.6	7.6	7.6	7.5	7.5	7.5
Stock Price (CHF)	388.5	604.0	720.5	956.0	1,226	1,452	1,250	1,235	1,235	1,235
Market Cap*	3,020	4,644	5,396	7,260	9,307	11,085	9,496	9,254	9,254	9,254
EPS net	14.02	29.52	37.12	48.85	58.33	65.47	76.19	78.33	85.29	96.78
PER net	27.7	20.5	19.4	19.6	21.0	22.2	16.4	15.8	14.5	12.8
CFPS	28.2	51.4	64.9	78.7	76.8	90.9	105.6	120.2	120.1	134.6
PCF	13.8	11.8	11.1	12.1	16.0	16.0	11.8	10.3	10.3	9.2
P/NAV	3.4	4.3	4.6	5.0	6.0	5.7	5.2	4.3	3.6	3.0
ROCE	9.4%	22.6%	26.9%	29.2%	33.8%	35.3%	41.7%	33.5%	32.4%	31.1%
ROE	12.6%	21.9%	25.2%	27.0%	29.9%	26.8%	39.1%	28.3%	26.0%	24.6%
EV	2,618	4,151	4,958	6,830	9,325	10,884	9,475	8,595	8,298	8,084
EV / Sales	1.1	1.7	1.7	2.1	2.4	2.5	2.0	1.7	1.6	1.4
EV / EBITDA	8.4	10.5	9.8	10.6	11.7	12.0	9.3	8.3	7.4	6.4
EV / EBIT	20.6	14.2	13.0	13.6	14.9	15.8	10.1	10.6	9.3	8.0
Yield %	1.6%	1.2%	1.3%	1.2%	4.2%	1.6%	2.8%	4.1%	2.2%	2.4%

* 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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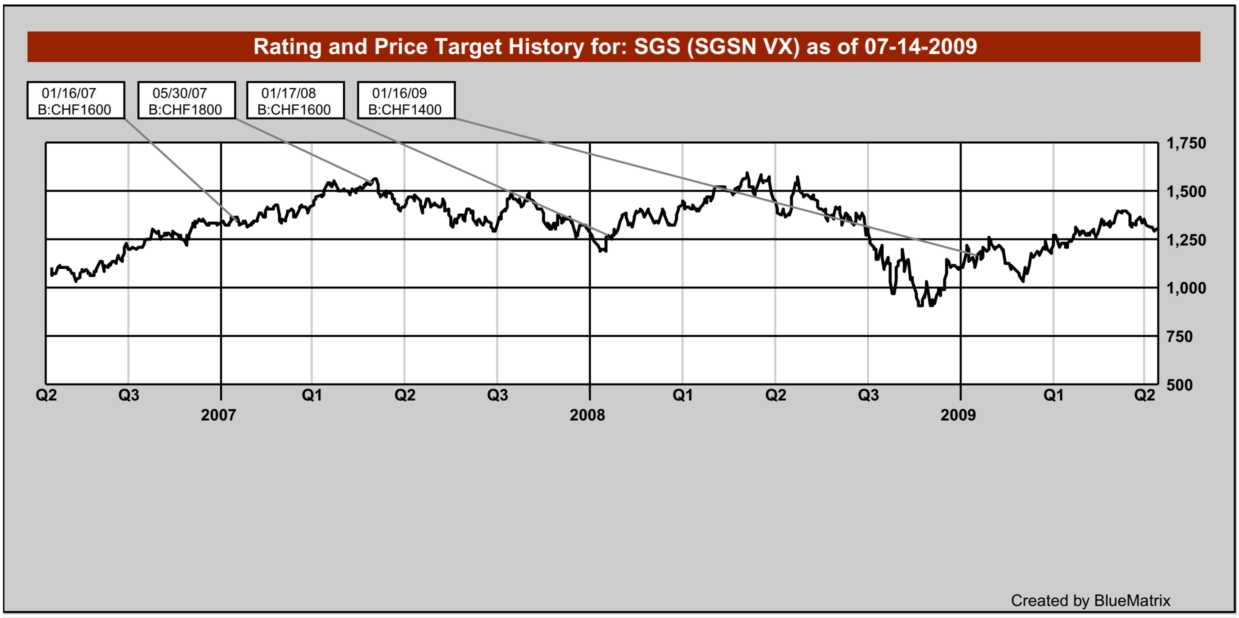

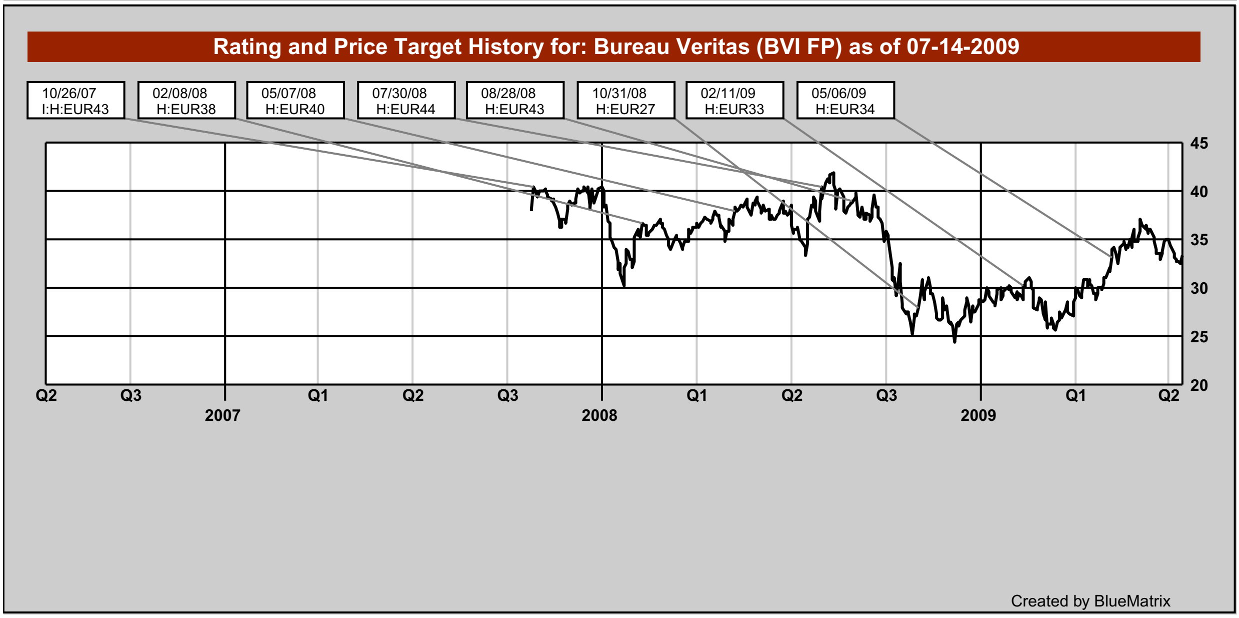

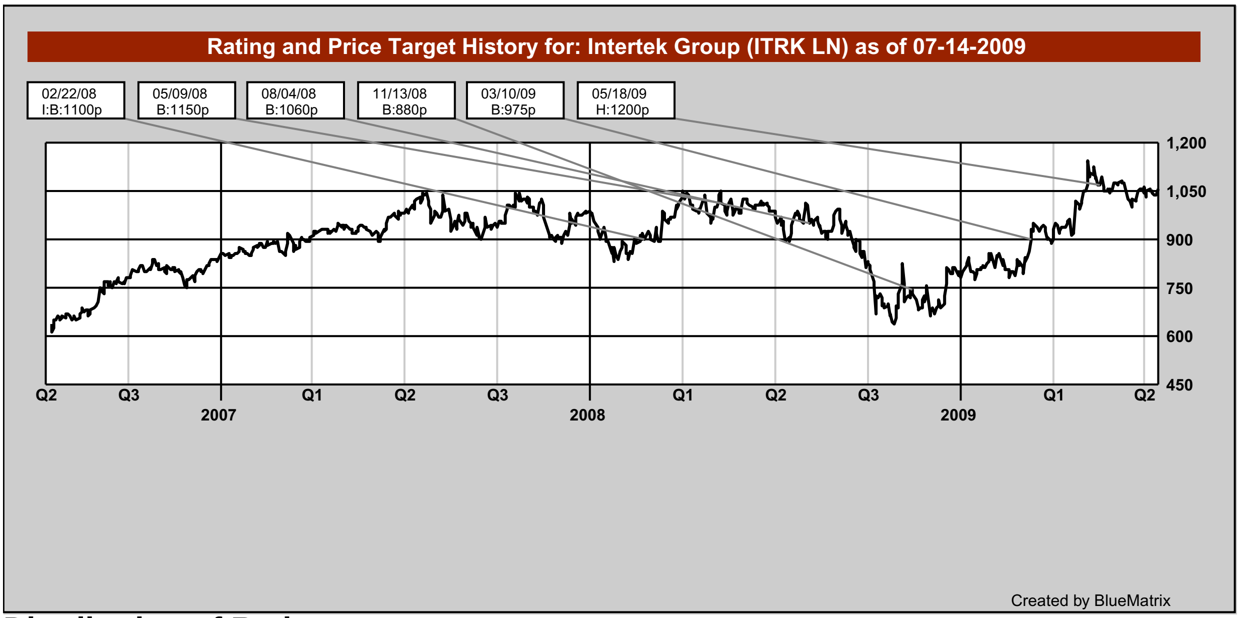

Distribution of Ratings

Rating	Count	Percent	IB Serv./Past 12 Mos. Count	IB Serv./Past 12 Mos. Percent
BUY [BUY/ SB]	416	51.80	46	11.06
HOLD [HOLD]	319	39.70	19	5.96
SELL [SU/ UNPF]	68	8.50	6	8.82

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