

## Equity Research Switzerland

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## No major acquisitions on the table at present

Worldwide GDP growth is a good indicator for SGS stock. A repeat of last year's global GDP growth rate of 4% is not expected for FY 2005. Nevertheless, SGS should profit from robust growth in Asia. The World Bank estimates that worldwide trade volume will expand by 7.5% in FY 2005. Acquisitions are the second share-price driver for SGS stock. Although we saw a high probability of a large-scale acquisition in our last study, we are now revising our view and believe that the new CEO will adhere to the current strategy of executing smaller takeovers in key business segments. SGS' valuation reflects the group's formidable market position. Upside potential is limited at the moment (fair value of CHF 900 per share according to our DCF model in the 9 February 2005 study).

**Organic growth likely to exceed 8% for FY 2005 and FY 2006:** Despite the slight decline in worldwide GDP growth compared to FY 2004, we expect SGS to post high organic growth rates in the future, mainly because exports and imports are accounting for an increasing share of developing countries' GDP.

**Asia is a growth driver:** In its 1Q 2005 financial filing, Intertek disclosed that the group achieved its greatest sales growth in Asia while its textile testing business in Europe and the Americas experienced declining revenues. SGS' Asian sales factor is estimated at 1.3 times that of Intertek and 2.3 times that of Bureau Veritas. SGS is stronger in Asia than its rivals and stands to profit the most from the vibrant growth in this region.

**Limited upside potential at the moment:** SGS' internal objective to become the world's most competitive service organization necessitates larger-scale acquisitions. At present, however, we see little probability of a major acquisition. Our DCF model calculates a fair value of CHF 900 per SGS share.



PER SHARE DATA	
Price SGSN.VX on 19-05-05 CHF	853.00
No. of shares SGSN.VX in '000	7,650
Market cap. SGSN.VX (CHF mns)	6,526
Other market cap. (CHF mns)	0
Total market capitalization (CHF mns)	6,526
Free float %	52
August von Finck & Family (voting: 24%)	24
Worms & Cie (voting: 24%)	24
Average daily trading volume (12 months)	21,655

SHARE VALUATION				
CHF	2003	2004	2005E	2006E
EPS	29.6	36.5	44.4	50.9
EPS growth %	111	23	22	14
P/E	28.8	23.4	19.2	16.8
CEPS	30.9	38.6	44.4	50.9
P/CE	27.6	22.1	19.2	16.8
Dividend	9.00	12.0	13.0	14.0
Dividend yield %	1.1	1.4	1.5	1.6
Book value	140	161	192	229
Price/Book	6.1	5.3	4.4	3.7
EV/EBITDA	15.8	12.9	10.7	9.2

HIGH	12-month	LOW
883.50		642.00

BREAKDOWN BY			
Sales 2004			
- by segment	CHF mns	change	Share
Agriculture	257	6%	9%
Minerals	320	14%	11%
Oil, Gas & Chemicals	575	31%	20%
Life Sciences	106	80%	4%
Consumer Testing	361	32%	13%
System & Services	235	3%	8%
Industrial	380	15%	13%
Environmental	209	21%	7%
Automotive	188	-11%	7%
Trade Assurance	255	16%	9%
Total	2,886	18%	100%

KEY DATA			
CHF mns	2004	2005E	2006E
Sales	2,885	3,143	3,400
EBIT	394	462	522
EBIT margin %	13.7	14.7	15.4
Shareholders' net profit	279	340	389
Return on equity %	22.7	23.1	22.2
Total assets	2,212	2,300	2,350
Equity	1,255	1,490	1,771
Equity ratio %	56.7	64.8	75.4
Interest-bearing debt	38.0	38.0	38.0
Cash	471	661	895
Operating cash flow	425	462	514
Capex	-200	-180	-180

EXCESS PERFORMANCE		
	SPIX <sup>1</sup>	DJSFISV <sup>2</sup>
3M	-3.9%	1.0%
6M	4.3%	1.9%
12M	14.4%	2.6%

<sup>1</sup>SPI ex Div.

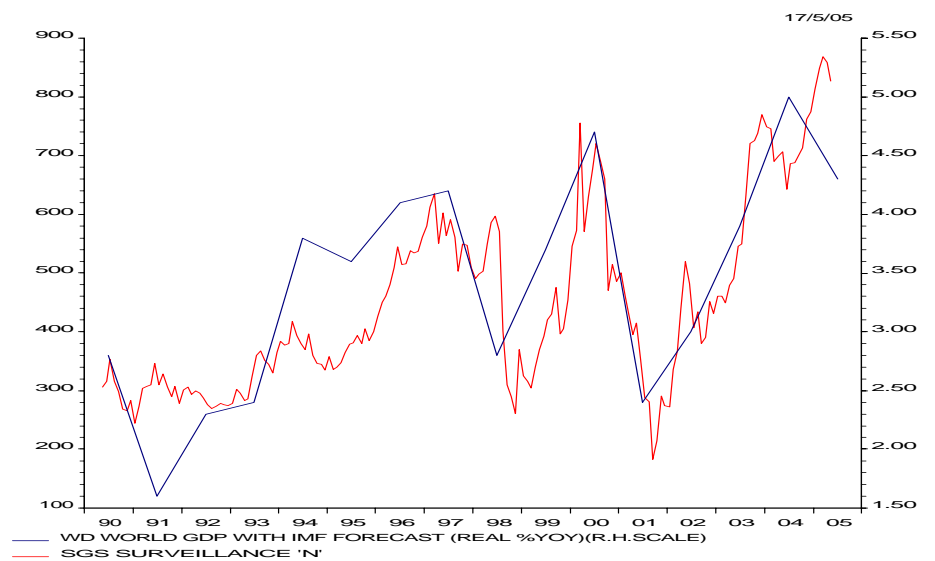
<sup>2</sup>DJ STOXX Financial Services

## Growth drivers for SGS stock

### Share price correlates with worldwide GDP growth

The chart below shows that worldwide GDP growth is a good indicator for SGS stock. Worldwide real economic growth in FY 2004 clocked in at a high +4%. We expect a decline in US growth (GDP FY 2004: +4.4%; VontE 2005E: +3.0%) and subdued EU consumer confidence (GDP FY 2004: +1.6%; VontE 2005E: +1.5%) to induce a mild slowdown in global economic activity for FY 2005. The rising price of oil could shave an estimated half percentage point off GDP growth.

**REAL GDP (ANNUAL GROWTH RATE IN %) AND SGS SHARE PRICE**



Source: Datastream

Source: DATASTREAM

### Organic growth above 8% possible for FY 2005/06E

Despite a slight slowdown in worldwide GDP growth, we expect SGS to post organic growth of 9% for FY 2005 and 8% for FY 2006. The following factors are the main revenue drivers, in our opinion:

- the dismantling of trade barriers;
- the increasing regulation of compulsory standards driven by customer demands regarding product quality;
- improved logistics and IT systems enable efficient worldwide trade;
- the corporate outsourcing trend;
- globalization (in the 1980s, exports and imports accounted for 30% of GDP for developing regions like China, India or Africa; this figure is now above 40% today and looks set to climb above 50% over the next decade).

### Forty percent of world trade is still not inspected or tested

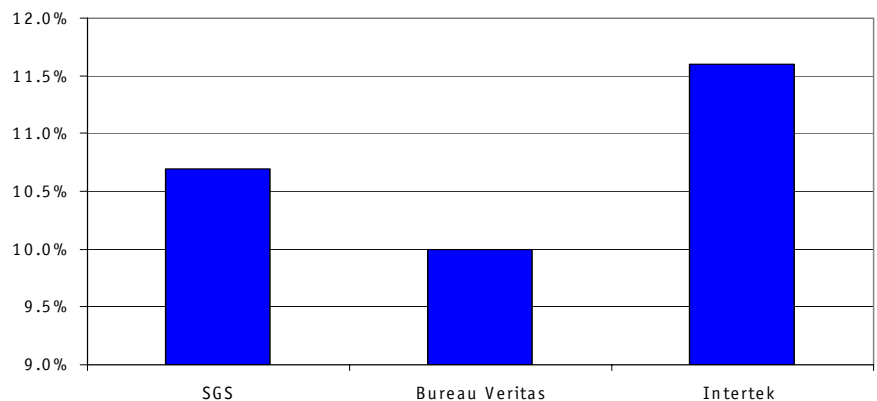
One important fact is that 40% of world trade is still not subjected to inspection or testing. This percentage is bound to drop dramatically in the coming years because quality consciousness on the part of customers is continually increasing. Therein lies another key growth driver of the SGS business model.

## Peer group comparison indicates fair valuation

**SGS' revenue growth is comparable to that of Intertek and Bureau Veritas**

SGS' two main rivals are Intertek and Bureau Veritas. The chart below displays organic revenue growth for FY 2004, which came to 10.7% for SGS. World trade expanded by 8.5% in FY 2004. The organic growth rates for all three firms thus exceeded the world trade growth figure.

**ORGANIC GROWTH RATES FOR FY 2004**



Source: SGS, Bureau Veritas, Intertek

**SGS and Intertek are similarly valued**

A comparison of valuation ratios for the three main competitors in the industry reveals that SGS and Intertek are similarly valued in terms of P/E and EV/EBITDA multiples. It is more difficult to draw a comparison with Bureau Veritas because that company is privately held. French holding company Wendel Investissement now owns 100% of Bureau Veritas (Bureau Veritas is one of ten equity holdings owned by Wendel). The comparison shows that Wendel is trading at a steep discount to Intertek and SGS.

**PEER GROUP COMPARISON**

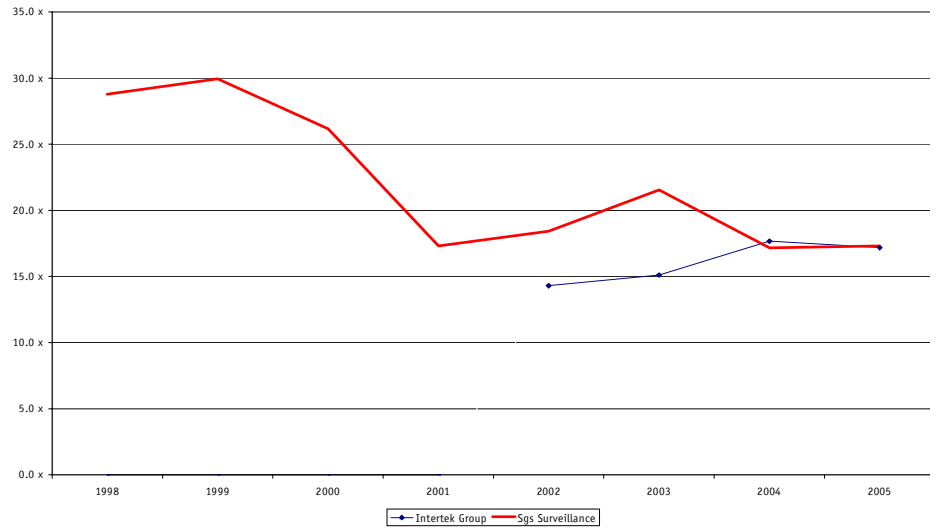
Company	Currency	Price	Change	Market cap.	P/E	P/E	EV/EBITDA	EV/EBITDA
		18-05-05	YTD %		05E	06E	05E	06E
Intertek Group	GBP	749	6%	1,158	18.3	15.6	10.7	9.2
Wendel Investissement	EUR	61	14%	3,505	14.7	12.0	8.4	7.8
SGS Surveillance	CHF	828	4%	6,477	18.6	16.3	10.4	9.3

Source: Vontobel Equity Research

**Similar revenue growth and EBITA margins**

Historically, SGS had always traded at a premium to Intertek, but that hasn't been the case since FY 2004. A valuation in line with Intertek makes sense in view of the two companies' comparable revenue growth rates and EBITA margins. The chart on the next page illustrates the convergence of the two companies' P/Es.

**HISTORICAL P/E (T+1): SGS VERSUS INTERTEK**



Source: JCF Group, Vontobel Equity Research

**SGS outperforms Intertek and the SPI**

The next chart tracks SGS' outperformance relative to Intertek and the Swiss Performance Index (SPI).

**RELATIVE PERFORMANCE OF SGS VERSUS INTERTEK AND THE SPI**

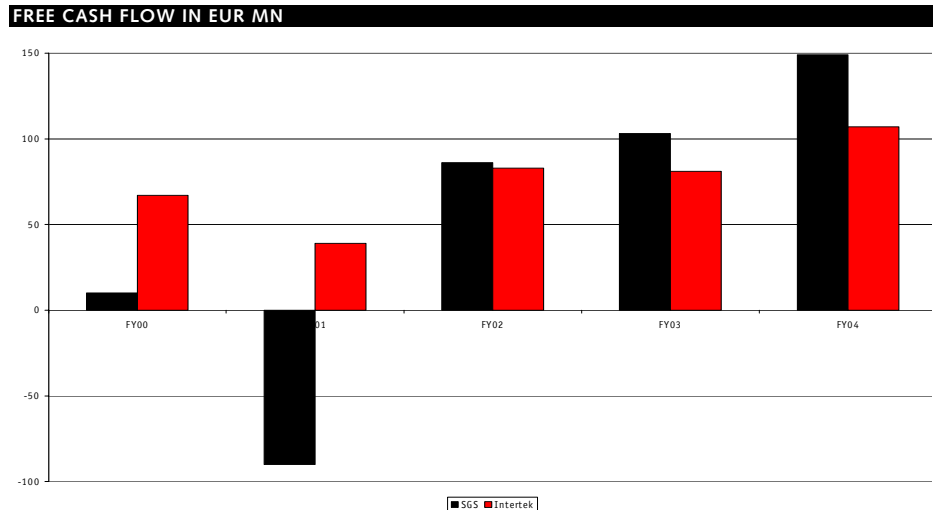
Price Base 100 for Sgs Surveillance (Registered) (CH) in CHF as of 18/05/05



Source: JCF Group

**SGS has the most potential to make acquisitions**

With a war chest estimated at CHF 3.6 bn, SGS has greater scope for acquisitions than Wendel and Intertek. Wendel Investissement allocates Bureau Veritas a budget of EUR 100 mn a year for acquisitions. Intertek finished FY 2004 with a net debt load of GBP 112 mn while SGS registered a net cash position of CHF 438 mn. Moreover, SGS has been generating higher free cash flows than Intertek since FY 2002.



Source: SGS, Intertek

**The reduced probability of a large-scale acquisition...**

In our last study, we identified major acquisitions as being a main share-price driver, but we now see little probability of SGS taking over a company like Bureau Veritas anytime soon. Instead, new CEO Dan Kerpelman will probably attempt to get the Life Sciences Services division up to speed via smaller acquisitions. The internal objectives for this division foresee a revenue target of around CHF 400 mn and a 20% EBIT margin by end-FY 2006 (FY 2004: revenue of CHF 107 mn and an EBIT margin of 12%).

**...increases the odds for share buybacks**

SGS could buy back CHF 170 mn worth of its own shares in FY 2005. That would support the 2005 EPS target of CHF 45. It could also enable SGS to achieve its EPS goal without reaching its EBITA margin target (16%). The group estimates that continual operational improvements (Six Sigma) alone give each division the potential to boost their EBITA margins by 1 to 1.5 percentage points.

**Limited upside potential; fair value of CHF 900 per share**

SGS' valuation reflects the group's earnings momentum and formidable market position. SGS has substantially increased its earnings capacity in recent years. The group's future acquisition policy will probably be the main share-price driver for SGS stock. At the moment, we see little probability of a large-scale acquisition. We expect the group to continue pursuing its present strategy of executing smaller takeovers in strategically important business segments. SGS is stronger in Asia than its rivals, which would justify a certain market-leadership premium over Intertek. We are reaffirming our Market Perform rating for the time being.

**DIVISIONAL REVENUE AND EBITA IN CHF MN**

	FY03	FY04	FY05E	FY06E		FY03	FY04	FY05E	FY06E
<b>Agricultural Services</b>	242	257	265	275	<b>Systems &amp; Services Certification</b>	230	235	255	275
- total growth (%)	-3.4	6.3	3.1	3.8	- total growth (%)	10.4	2.5	8.3	7.8
- as % of total group	9.9	8.9	8.4	8.1	- as % of total group	9.4	8.2	8.1	8.1
EBITA	24.3	23.6	28.0	32.0	EBITA	34.7	30.5	39.0	41.0
- total growth (%)	-0.8	-2.9	18.6	14.3	- total growth (%)	45.8	-12.1	27.9	5.1
- as % of total group	8.1	6.0	6.1	6.1	- as % of total group	11.6	7.8	8.4	7.9
Operating margin (%)	10.0	9.2	10.6	11.6	- Operating margin (%)	15.1	13.0	15.3	14.9
<b>Minerals Services</b>	280	320	350	380	<b>Industrial Services</b>	330	380	410	440
- total growth (%)	4.3	14.1	9.5	8.6	- total growth (%)	8.2	15.1	8.0	7.3
- as % of total group	11.4	11.1	11.1	11.2	- as % of total group	13.4	13.2	13.0	12.9
EBITA	35.5	46.3	50.0	55.0	EBITA	34.9	46.1	52.0	57.0
- total growth (%)	29.1	30.4	8.0	10.0	- total growth (%)	24.6	32.1	12.8	9.6
- as % of total group	11.8	11.8	10.8	10.5	- as % of total group	11.6	11.8	11.3	10.9
Operating margin (%)	12.7	14.5	14.3	14.5	Operating margin (%)	10.6	12.1	12.7	13.0
<b>Oil, Gas &amp; Chemicals Services</b>	439	575	610	650	<b>Environmental Services</b>	172	209	223	238
- total growth (%)	10.1	30.9	6.2	6.6	- total growth (%)	11.0	21.3	6.9	6.7
- as % of total group	17.9	19.9	19.4	19.1	- as % of total group	7.0	7.2	7.1	7.0
EBITA	47.9	68.6	80.0	91.0	EBITA	11.2	16.8	23.0	27.0
- total growth (%)	54.0	43.2	16.6	13.8	- total growth (%)	60.0	50.0	36.9	17.4
- as % of total group	16.0	17.5	17.3	17.4	- as % of total group	3.7	4.3	5.0	5.2
Operating margin (%)	10.9	11.9	13.1	14.0	Operating margin (%)	6.5	8.1	10.3	11.3
<b>Life Science Services</b>	59	107	120	135	<b>Automotive Services</b>	211	188	220	240
- total growth (%)	3.5	80.2	12.7	12.5	- total growth (%)	-12.3	-11.0	17.2	9.1
- as % of total group	2.4	3.7	3.8	4.0	- as % of total group	8.6	6.5	7.0	7.1
EBITA	5.9	12.8	15.0	18.0	EBITA	20.8	20.0	25.0	28.0
- total growth (%)	59.5	116.9	17.2	20.0	- total growth (%)	20.9	-3.8	25.0	12.0
- as % of total group	2.0	3.3	3.2	3.4	- as % of total group	6.9	5.1	5.4	5.4
Operating margin (%)	10.0	12.0	12.5	13.3	Operating margin (%)	9.9	10.7	11.4	11.7
<b>Consumer Testing Services</b>	272	361	420	480	<b>Trade Assurance Services</b>	220	255	270	287
- total growth (%)	-8.9	32.4	16.5	14.3	- total growth (%)	4.7	16.4	5.7	6.3
- as % of total group	11.1	12.5	13.4	14.1	- as % of total group	8.9	8.9	8.6	8.4
EBITA	39.4	65.2	86.0	105.0	EBITA	45.1	61.5	64.0	68.0
- total growth (%)	33.6	65.5	31.9	22.1	- total growth (%)	93.6	36.4	4.1	6.3
- as % of total group	13.1	16.7	18.6	20.1	- as % of total group	15.0	15.7	13.9	13.0
Operating margin (%)	14.5	18.1	20.5	21.9	Operating margin (%)	20.5	24.1	23.7	23.7

Quelle: Vontobel Equity Research

<b>CONSOLIDATED FINANCIAL DATA (CHF MNS)</b>							
	2000	2001	2002	2003	2004	2005E	2006E
<b>REVENUES</b>	<b>2,369</b>	<b>2,332</b>	<b>2,392</b>	<b>2,454</b>	<b>2,885</b>	<b>3,143</b>	<b>3,400</b>
- change (%)	-23	-2	3	3	18	9	8
EBITDA	257	247	311	396	498	577	644
- change (%)	-21	-4	26	27	26	16	12
- as % of revenues	10.9	10.6	13.0	16.1	17.3	18.4	18.9
DEPRECIATION	-104	-101	-95	-96	-107	-115	-122
- as % of revenues	4.4	4.3	4.0	3.9	3.7	3.7	3.6
EBITA BEF. E.O. ITEMS	154	146	216	300	391	462	522
- change (%)	-16	-5	48	39	31	18	13
- as % of revenues	6.5	6.2	9.0	12.2	13.6	14.7	15.4
E.O. ITEMS	9	-178	-80	3	3	0	0
<b>EBITA</b>	<b>162</b>	<b>-32</b>	<b>136</b>	<b>303</b>	<b>394</b>	<b>462</b>	<b>522</b>
- change (%)	-14	-120	-526	123	30	17	13
- as % of revenues	6.8	-1.4	5.7	12.3	13.7	14.7	15.4
GOODWILL AMORTISATION	-4	-8	-9	-10	-16	0	0
EBIT	158	-40	127	293	378	462	522
- change (%)	-14	-120	-526	123	30	17	13
- as % of revenues	6.7	-1.7	5.3	11.9	13.1	14.7	15.4
FINANCIAL RESULT	25	17	13	10	6	10	12
PRETAX PROFIT	183	-23	140	303	384	472	534
- change (%)	3	-113	-704	116	27	23	13
- as % of revenues	7.7	-1.0	5.9	12.3	13.3	15.0	15.7
TAXES	-51	-44	-27	-68	-90	-117	-128
- tax rate (%)	28	-187	20	22	23	25	24
GROUP NET PROFIT	131	-67	113	235	294	355	406
- change (%)	10	-151	-269	108	25	21	14
- as % of revenues	5.5	-2.9	4.7	9.6	10.2	11.3	11.9
MINORITY INTERESTS	-7	-8	-4	-8	-15	-15	-17
<b>SHAREHOLDERS' NET PROFIT</b>	<b>124</b>	<b>-75</b>	<b>109</b>	<b>227</b>	<b>279</b>	<b>340</b>	<b>389</b>
- change (%)	-59	-160	-245	108	23	22	14
- as % of equity shareholder	11.3	-7.7	12.2	21.1	22.7	23.1	22.2
Cash flow from operations	239	142	301	325	425	462	514
- change (%)	-13	-82	404	57	23	13	12
- as % of revenues	10.1	1.8	9.1	13.9	14.5	15.0	15.5
Capital expenditures	-99	-117	-121	-171	-200	-180	-180
-5-year average	-157	-148	-141	-139	-141	-158	-170
<b>DATA PER REGISTERED (CHF, ADJ)</b>							
EARNINGS	15.9	-9.6	14.0	29.6	36.5	44.4	50.8
- change (%)	-59	-160	246	111	23	22	14
CASH EARNINGS PER SHARE	16.5	-8.5	15.2	30.9	38.6	44.4	50.8
DIVIDEND	5.8	6.0	7.3	9.0	12.0	13.0	14.0
- payout ratio (%)	36	-62	52	30	33	29	28
CASH FLOW	31	18	39	42	56	60	67
BOOK VALUE	141	125	115	140	161	192	229
TOTAL ASSETS	2,122	1,991	1,850	2,022	2,212	2,300	2,350
CASH	642	649	531	526	471	661	895
NET DEBT	-488	-446	-402	-493	-433	-623	-857
- as % of group equity	-44	-44	-44	-45	-35	-42	-48
GOODWILL AND INTANGIBLES	33	60	107	147	304	304	304
EQUITY SHAREHOLDER	1,099	982	897	1,072	1,229	1,470	1,751
GROUP EQUITY	1,120	1,007	915	1,090	1,255	1,490	1,771
- as % of total assets	53	51	49	54	57	65	75
NO. OF REG. (MNS)	7.823	7.822	7.773	7.662	7.650	7.650	7.650

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