Jefferies International Ltd.

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Services Group
Diversified Commercial

Switzerland

SGS (VX: SGSN VX)

Certifiably Flexible

Investment Summary

While the shares have performed well and signs of a rebound remain tentative, the current valuation remains reasonable for what has proven to be a solidly defensive growth story.

Company Update
Price Target Change
Estimate Change

Rating:	BUY
Price:	CHF1,382.00
Price Target:	CHF1,550.00
Previous:	*CHF1,425.00*
Bloomberg:	VX: SGSN VX

Market Data

52-Week Range:	CHF1,430.00-CHF1,015.15
Total Entprs. Value (MM):	CHF9,840.0
Market Cap. (MM):	CHF10,365.0
Shares Out. (MM):	7.5
Avg. Daily Vol.:	23,667

Financial Summary

Net Debt (MM):	(CHF525.0)
Net Debt/Capital:	(20.0%)
Dividend Yield:	4.5%

CHF	2008A	2009A	2010E	2011E
Rev. (MM)	4818.0	4712.0	4901.0	5462.0
Prev.	--	*4820.9*	*4988.1*	*5556.4*
EV/Rev.	2.0x	2.1x	2.0x	1.8x
EBITDA (MM)	1,024.0	1,037.0	1,087.0	1,209.0
Prev.	--	*1,015.3*	*1,061.4*	*1,187.7*
EV/EBITDA	9.6x	9.5x	9.1x	8.1x
EPS				
FY Dec	**76.19**	**77.22**	**81.31**	**91.47**
Prev. FY	--	*76.36*	*80.23*	*90.31*
FY P/E	18.1x	17.9x	17.0x	15.1x
EBIT (MM)	809.8	792.0	836.0	944.0
EV/EBIT	12.2x	12.4x	11.8x	10.4x
Net Profit	579.0	566.0	609.7	685.9
Prev.	--	*563.6*	*601.2*	*676.7*

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Event

FY results review and price target increase.

Key Points

- **Is the trough behind us?** FY sales of CHF4.71b were well shy of our CHF4.82b forecast and were marked by an H2 LFL decline in sales of 1.2% (vs. our +2% forecast). H2 sales fell in 7 of 10 divisions and missed our forecasts in 8 of 10 as the lagged impact of slowing global growth took its toll. Despite that fairly grim picture, management remained sanguine on prospects for 2010, forecasting growth over both the full year and in H1 – where the comparables in the key consumer business will be difficult. That optimism was supported by a rebound in sales in late H2 after troughing in Sept./Oct.
- **Can margin momentum be sustained?** The highlight of the results release was the FY operating margin growth of 50bps – and H2 growth of 100bps. The performance was broad based, with a solid rebound in Minerals and Automotive, good stability in Consumer, and healthy expansion in the Certification and GIS divisions. Aside from some CPSIA tailwinds, the margin gains appear sustainable as mix gradually improves and the cost structures across the 10 divisions remain extremely flexible.
- **Is cash king? Catalysts lacking.** While M&A remains a pillar of SGS's business model, management's decision to distribute >75% of '09 EPS is a strong signal that the group does not see large opportunities in the offing. At the same time management played down the potential of taking part should a further von Finck share block become available (due in part to the tax implications of the purchase of greater than 5% of the capital).

Valuation/Risks

On the back of the good H2 performance and some signs of a sales rebound we have increased our price target to CHF1,550 from CHF1,425. Our target is derived by applying SGS's average forward P/E through the '03-'08 cycle (19x) to forecast '10 EPS. While we believe P/E multiples in the forthcoming cycle will not attain the 20x+ seen in '07 due to a tougher M&A environment and weaker margin expansion prospects, on 17x the shares remain at the low end of the historical range despite SGS proving itself to be a solid defensive growth story. The key risk is continued weakness in the commodities businesses and the overhang from the von Finck shareholding.

Impact on Other Companies

SGS's indication that a trough was reached in Sept/Oct casts Bureau Veritas (BVI FP, Hold) and Intertek's (ITRK LN, Hold) weak mid term results in a slightly more positive light. Nonetheless, we see risk heading into BV's Q4 sales release as many of the group's key end markets (marine, construction, mining) remain challenging.

FY Results Review - (see table on pg. 4 for summary)

- **Sales** were the disappointment of the results release, with FY turnover of 4.71b coming in well shy of our 4.82b forecast. Along with a stronger than forecast currency headwinds, the group saw an unexpected organic decline in sales in H2 of 1.2% (vs. our +2% forecast). That decline was driven by falling sales in 7 of 10 divisions – with 8 of 10 divisions falling short of our forecasts.
- Despite the relatively weak turnover, **operating profitability** was very strong, with FY EBIT margin growth of 50bps and an extremely strong 100bps improvement in H2. The performance was broad based, with a solid rebound in Minerals and Automotive, good stability in Consumer, and healthy expansion in the Certification and GIS divisions.
- The mix of weaker top line and better profitability led to normalized **EPS** of CHF75.49 – a touch ahead of our CHF75.21 forecast.
- **Cash flow** was very solid over H2, with a much better than expected working capital inflow leading to FY free cash flow of CHF631m vs. our CHF452m forecast. As a result, net cash grew to ~CHF475m vs. our CHF325m forecast.

- The **Agricultural Services** division reported a disappointing H2, with sales down 1% LFL and a 150bps decrease in operating margin. The slowdown from what was a very strong H1 and despite a good global harvest was driven by reduced trading activities (due partly to lack of lending facilities for traders), weakness in the South American agricultural sector, and delayed soil testing business in the U.S. (due to tough weather conditions).
- Looking forward, management expects to recover some of the delayed U.S., but did highlight a relatively difficult first half comparison period. Longer term, the division's push upstream and increased global scrutiny of food supply chains should be key drivers of both top line and margin progression.
- We are forecasting 5.5% LFL expansion in 2009 as the H1 comparable is difficult, and 10bps margin improvement – with a much better H2.

- The **Minerals Services** division continued to struggle with muted demand and declined 12.6% LFL in H2 as global exploration capex levels were significantly lower and trade volumes declined. Despite the weak top line, the division posted a solid H2 margin recovery (+50bps y/y vs. -570bps in H1) on the back of restructuring and some recovery in higher margin analytical volumes.
- Management pointed to some signs of improving demand in late H2 after a very tough Q2/Q3 – although expects only flat global exploration capex in 2010. Key growth drivers remain gold and uranium, where spending is expected to finally be unleashed in 2010 after many miners took a wait and see approach in 2009 despite historically high prices. A recovery in base metals is not expected before H2 (at the earliest). While there have been some signs of pricing pressure on the back of industry overcapacity, management suggested the issue is localized, with only a few notable weak spots – most notably South America.
- For 2010 we are forecasting a continued fall in revenues in H1, and muted H2 recovery – leading to flat FY growth. Margins are expected to rebound to close to '08 levels, in line with the result produced in H2.

- The **Oil, Gas & Chemicals Services** division reported a 1.6% LFL H2 sales decline, but 50bps margin increase. The decline in the business was driven by continued weakness in chemicals and some slowing in refining. Upstream services did however, manage to grow over the half (driving the margin increase).
- Management expects the division to gradually recover in 2010 as the chemicals and refining segment grow in line with industrial production and upstream services remain strong. We are forecasting FY '10 LFL expansion of 6% (back end weighted) and a flat margin performance.

- **Life Sciences** saw an organic fall in sales of 0.7% in H2 on the back of slow demand for late stage services. Both the QA/QC and early stage businesses continued to grow over the period. While management is optimistic of a healthy 2010 recovery, our US CRO team still see a relatively muted rebound in demand and continued pricing pressure across the industry. SGS should be somewhat insulated from these trends given its large EU revenue base, but we nevertheless are estimating only marginal growth in 2010.

- The **Consumer Testing** business reported surprisingly strong H2 growth of 6.8% (vs. our 5% forecast) as the negative impact of tough CPSIA comps appears to have been less pronounced than that experienced by Bureau Veritas and Intertek. The 140bps H2 margin increase also outpaced our +110bps forecast as solid CPSIA driven margins appear to have been sustained despite the fall-off in the business.
- While noting tough CPSIA related Q1 comparables, management expects a 2010 recovery in E&E demand and to finally see some signs of REACH related revenues. Margins were also seen as sustainable. We are tabling 6.5% LFL expansion and a slight margin contraction for 2010.

- The **Systems & Certification** division reported slightly disappointing sales, but excellent H2 profitability. H2 LFL sales growth of 4.3% was shy of our 7% forecast which had assumed better growth in ISO9000 business linked

to the 3 year certification cycle. Growth in the division continues to be supported by sustainability related work. H2 operating margin of 23% (+280bps) was an exceptional performance in what has traditionally been a business with only modestly expanding profitability.
- Looking ahead we expect slower growth in 2010 as the trough of the ISO9000 cycle offsets sustainability related growth. We have pencilled in a flat 2010 margin performance pending greater clarity on the sustainability of the '09 performance.

- **Industrial Services** saw sales decline marginally in H2 on the back of slow construction markets in the developed world and some investment deferrals in the oil & gas business. Renewables based business continued however, to grow well over the period. For 2010 we are forecasting single digit LFL expansion in the business as construction related business remains moribund, which is expected to be offset by some recovery in energy related demand.

- **Environmental Services** reported sequential slowing (-1.9% from +4.7% in H1) which highlights the late cyclical exposure in the business. While regulation driven recurring testing was sustained, demand for remediation work has fallen off significantly due to weak construction demand and industrial output. Management saw some troughing in the business in H2, but has yet to see concrete signs of a recovery. As such, we are forecasting only marginal 2010 growth and flat margin (on already very solid '09 profitability levels.

- The **Automotive Services** division reported a much larger than expected organic decline in business (-9.2% vs. our -2% forecast) as a result of a very difficult OEM market and an in-sourcing of the Irish drivers license business. The remaining statutory businesses remained relatively strong over the period. Profitability in the quarter improved both y/y and sequentially as the division adjusted to the declining Irish business.
- Looking forward we expect a recovery in both the OEM (on a general rebound in the automotive sector) and statutory businesses (new contracts expected to more than offset lost Irish business).

- As expected, the **Government and Institutions Services** (GIS) division reported sequential slowing from H1 (10% to 4.9% LFL) as the PSI business struggled with reduced trade volumes. On the positive side, the product conformity and scanner businesses both continued to grow in H2 and SGS announced new contract wins in Ghana and Mozambique. Looking ahead, PSI (now slightly less than 50% of the division's turnover) is expected to remain difficult in 2010 - although there are no contracts slated for termination over the year.

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SGS Results Analysis

Total	FY '08 Actual	FY '09 Actual	FY '09 Jefco Est.	
Revenues	4,818	4,712	4,821	
% Growth	10.2%	-2.2%	0.1%	
LFL Growth (%)	*15.3%*	*1.3%*	*2.9%*	H2 down 1.3% LFL (vs. our 2% forecast)
Perimeter Effect (%)	*2.5%*	*1.1%*	*1.1%*	
Currency Impact (%)	*-7.6%*	*-4.6%*	*-3.9%*	
Operating Profit	809.8	814.0	806.8	
Operating Margin	16.8%	17.3%	16.7%	H2 up 100bps y/y
Net Profit	**692.0**	**566.0**	**564.0**	
EPS	**91.09**	**75.49**	**75.21**	

	FY '08 Actual	FY '09 Actual	FY '09 Jefco Est.	
Agricultural Services				
Sales	358.3	356.3	380.6	Significant slowing from H1 on poor trading volumes, export restrictions and slower soil testing business in the U.S. due to weather conditions. H1'10 a tough comp, but delayed soil testing business expected to be recouped in 2010.
LFL Growth (%)	*9.3%*	*4.0%*	*9.0%*	
Operating Profit	55.9	57.1	64.5	
Operating Margin	*15.6%*	*16.0%*	*16.9%*	
Minerals Services				
Sales	631.6	536.0	558.4	Continued deterioration in H2, but some signs that business troughed in Q2/Q3. Margin improves from H1 on restructuring benefits. Early signs of exploration pick up in Q4 ahead of 2010 season - growth expected to come from gold and uranium.
LFL Growth (%)	*27.6%*	*-10.3%*	*-9.0%*	
Operating Profit	115.8	86.3	83.0	
Operating Margin	*18.3%*	*16.1%*	*14.9%*	
Oil, Gas & Chemical Services				
Sales	984.8	951.0	957.3	Slight fall off from 2% in H1 as chemicals remains weak and refining much slower in H2. Upstream services continue to grow. Chemicals expected to bounce in 2010 with improving global industrial production.
LFL Growth (%)	*11.6%*	*0.1%*	*2.0%*	
Operating Profit	149.7	146.4	142.2	
Operating Margin	*15.2%*	*15.4%*	*14.9%*	
Life Sciences Services				
Sales	204.4	201.3	213.6	H2 flat - despite some early signs in Q2 that market was improving. Late stage work remains slow, early stage and QC demand grows. Business being sheltered by European exposure where capacity issues and pricing pressure more moderate.
LFL Growth (%)	*9.2%*	*3.1%*	*7.8%*	
Operating Profit	27.5	28.0	27.6	
Operating Margin	*13.5%*	*13.9%*	*12.9%*	
Consumer Testing Services				
Sales	733.0	789.0	788.6	Sales grow mid single digits in H2 despite difficult comparison basis. Good H2 margin performance given CPSIA maturity. REACH and an E&E rebound key drivers of a potential 2010 reacceleration in growth.
LFL Growth (%)	*16.9%*	*9.1%*	*8.4%*	
Operating Profit	170.2	200.0	198.5	
Operating Margin	*23.2%*	*25.3%*	*25.2%*	
Systems & Services Certification				
Sales	366.5	367.3	372.9	Slightly disappointing H2 sales given ISO9000 cycle peak, but significant margin improvement on better geographic mix. Margin performance seen as sustainable.
LFL Growth (%)	*9.7%*	*4.6%*	*6.2%*	
Operating Profit	70.2	77.6	74.0	
Operating Margin	*19.2%*	*21.1%*	*19.8%*	
Industrial Services				
Sales	738.5	743.6	756.9	H2 negative LFL on tough construction markets in Spain, US and Middle East and some deferrals in oil & gas infrastructure projects.
LFL Growth (%)	*16.7%*	*2.2%*	*4.0%*	
Operating Profit	105.5	103.4	105.2	
Operating Margin	*14.3%*	*13.9%*	*13.9%*	
Environmental Services				
Sales	296.4	287.7	297.4	Significant slowing from H1 as remediation related work fell off due to slow construction demand and industrial output. Some signs of Q4 troughing in business, but no concrete signs yet of recovery.
LFL Growth (%)	*10.4%*	*1.1%*	*3.8%*	
Operating Profit	31.4	33.6	32.4	
Operating Margin	*10.6%*	*11.7%*	*10.9%*	
Automotive Services				
Sales	292.6	266.2	277.4	Significantly negative H2 LFL on tough comps in Ireland and weak OEM business. Ex-Ireland statutory business performs well.
LFL Growth (%)	*23.8%*	*-4.3%*	*-0.9%*	
Operating Profit	47.7	42.4	40.8	
Operating Margin	*16.3%*	*15.9%*	*14.7%*	
Governments & Institutions Services				
Sales	211.9	214.0	217.9	H2 slows significantly as PSI business (now slightly <50% of turnover) reduced on weaker trade volumes. PCA and scanner businesses performing well and new contracts announced in Q4 in Ghana and Mozambique.
LFL Growth (%)	*11.1%*	*6.9%*	*5.7%*	
Operating Profit	35.9	39.3	38.6	
Operating Margin	*16.9%*	*18.4%*	*17.7%*	

Source: Company data and Jefferies Research

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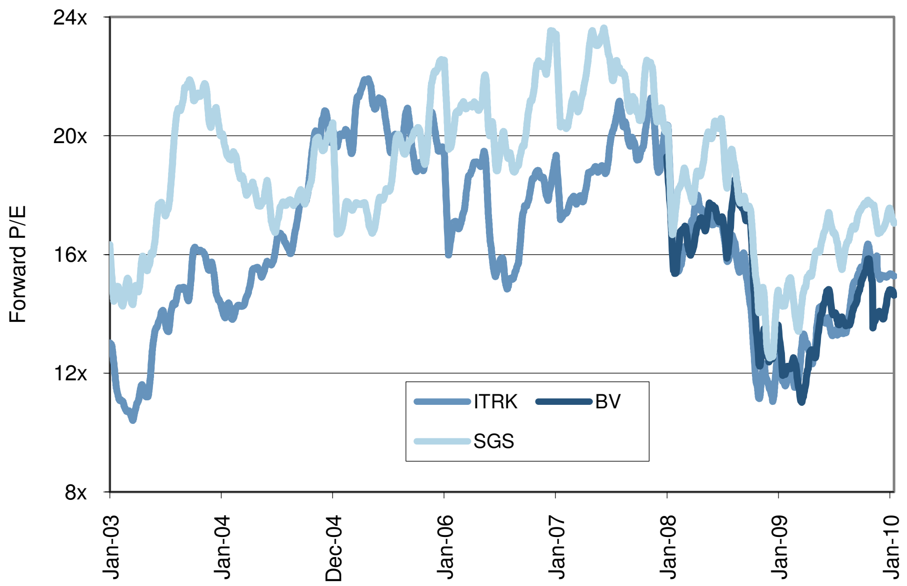
Historical Multiple Evolution



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December year end	2002	2003	2004	2005	2006	2007	2008	2009	2010E	2011E	2012E
Income Statement (CHFm)											
Turnover	2392.0	2454.0	2885.0	3308.0	3821.0	4372.0	4818.0	4712.0	4901.4	5462.0	6109.8
% change	2.6%	2.6%	17.6%	14.7%	15.5%	14.4%	10.2%	-2.2%	4.0%	11.4%	11.9%
EBITDA	311.0	396.0	508.0	642.0	800.0	908.0	1024.0	1037.0	1087.0	1209.4	1354.5
margin %	13.0%	16.1%	17.6%	19.4%	20.9%	20.8%	21.3%	22.0%	22.2%	22.1%	22.2%
EBIT	127.0	293.0	380.0	502.0	623.8	690.0	937.0	794.0	853.8	963.1	1087.3
margin %	5.3%	11.9%	13.2%	15.2%	16.3%	15.8%	19.4%	16.9%	17.4%	17.6%	17.8%
Pre-Tax	140.0	303.0	386.0	507.0	622.8	692.0	933.0	791.0	854.5	963.9	1088.1
Net income	109.0	227.0	278.0	371.0	442.8	500.0	692.0	566.0	609.7	685.9	772.2
margin %	4.6%	9.3%	9.6%	11.2%	11.6%	11.4%	14.4%	12.0%	12.4%	12.6%	12.6%
Balance Sheet (CHFm)	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010E**	**2011E**	**2012E**
Working Capital	216.0	196.0	139.0	223.0	252.0	256.0	274.0	200.0	206.8	230.4	257.7
WC as a % of turnover	9.0%	8.0%	4.8%	6.7%	6.6%	5.9%	5.7%	4.2%	4.2%	4.2%	4.2%
Capital Employed	1263.0	1332.0	1497.0	1943.0	1747.0	2160.0	2331.0	2749.0	2735.7	3002.0	3358.4
Net Debt	-402.0	-493.0	-438.0	-430.0	18.0	-201.0	-21.0	-479.0	-524.8	-578.8	-689.4
Gearing	-44.8%	-46.0%	-37.7%	-29.9%	1.2%	-10.4%	-1.2%	-23.4%	-23.8%	-23.7%	-24.9%
Cash Flow (CHFm)	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010E**	**2011E**	**2012E**
Cash Flow	219.0	395.0	486.0	598.0	582.8	694.0	802.0	827.0	869.7	962.5	1073.5
Capex	-121.0	-171.0	-201.0	-205.0	-224.0	-271.0	-278.0	-209.0	-245.1	-273.1	-305.5
WCR	32.0	-70.0	-61.0	-187.0	-31.0	12.0	-22.0	13.0	-6.8	-23.6	-27.3
Free-Cash Flow	130.0	154.0	224.0	206.0	327.8	435.0	502.0	631.0	617.9	665.7	740.7
Key Valuation Ratios	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010E**	**2011E**	**2012E**
Shares Outstanding (m)	7.8	7.7	7.5	7.6	7.6	7.6	7.6	7.5	7.5	7.5	7.5
Stock Price (CHF)	388.5	604.0	720.5	956.0	1,226	1,452	1,250	1,197	1,382	1,382	1,382
Market Cap*	3,020	4,644	5,396	7,260	9,307	11,085	9,496	8,975	10,362	10,362	10,362
EPS net	14.02	29.52	37.12	48.85	58.33	65.47	76.19	77.22	81.31	91.47	102.99
PER net	27.7	20.5	19.4	19.6	21.0	22.2	16.4	15.5	17.0	15.1	13.4
CFPS	28.2	51.4	64.9	78.7	76.8	90.9	105.6	110.3	116.0	128.4	143.2
PCF	13.8	11.8	11.1	12.1	16.0	16.0	11.8	10.9	11.9	10.8	9.7
P/NAV	3.4	4.3	4.6	5.0	6.0	5.7	5.2	4.4	4.7	4.2	3.7
ROCE	9.4%	22.6%	26.9%	29.2%	33.8%	35.3%	41.7%	31.3%	31.1%	33.6%	34.2%
ROE	12.6%	21.9%	25.2%	27.0%	29.9%	26.8%	39.1%	28.9%	28.8%	29.3%	29.1%
EV	2,618	4,151	4,958	6,830	9,325	10,884	9,475	8,496	9,837	9,783	9,673
EV / Sales	1.1	1.7	1.7	2.1	2.4	2.5	2.0	1.8	2.0	1.8	1.6
EV / EBITDA	8.4	10.5	9.8	10.6	11.7	12.0	9.3	8.2	9.1	8.1	7.1
EV / EBIT	20.6	14.2	13.0	13.6	14.9	15.8	10.1	10.7	11.5	10.2	8.9
Yield %	1.6%	1.2%	1.3%	1.2%	4.2%	1.6%	2.8%	4.2%	4.3%	4.3%	4.3%

* historical data are average figures
source: Jefferies International Ltd.

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Company Description

SGS is the largest global inspection, testing, verification and certification player. 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.

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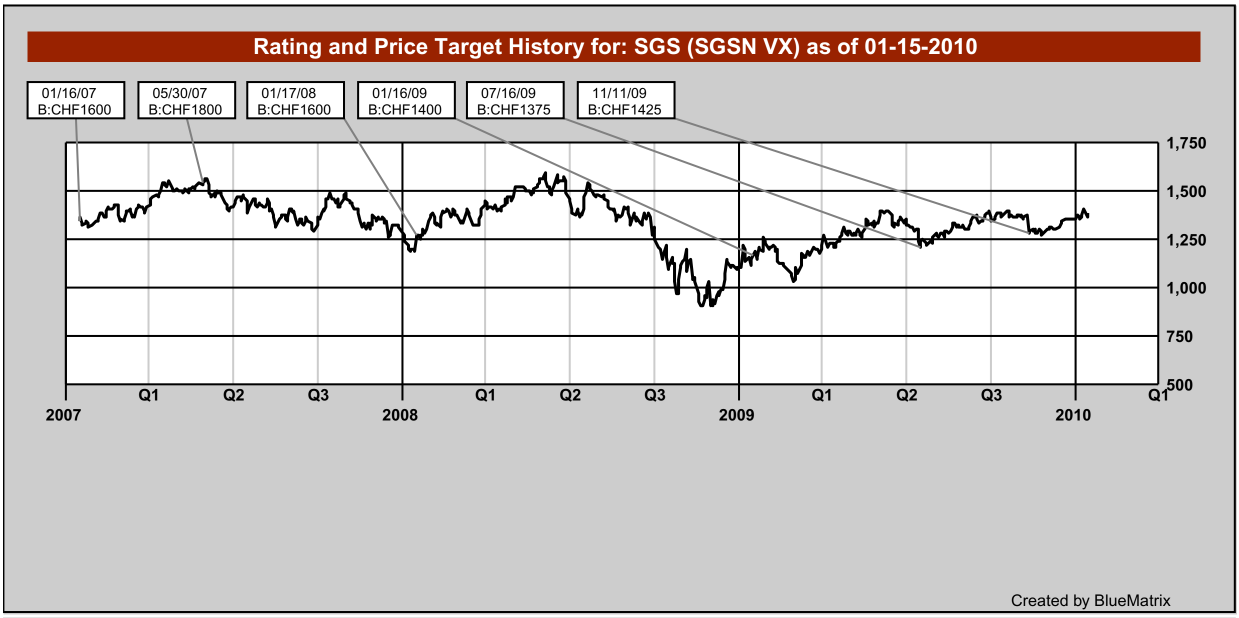

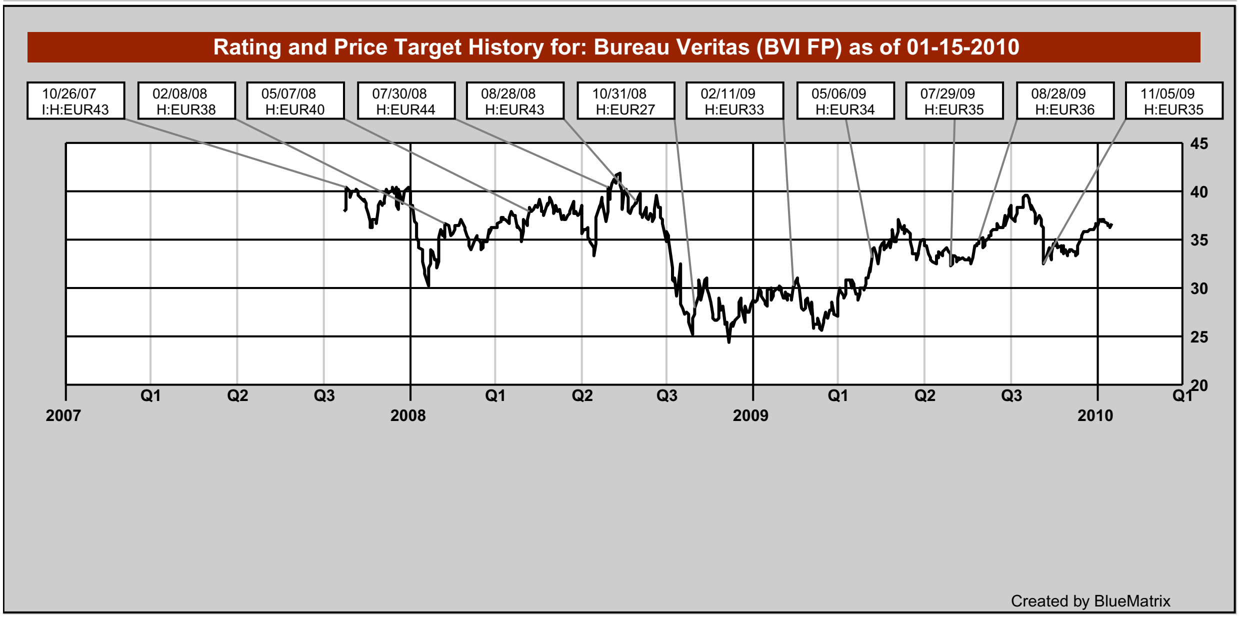

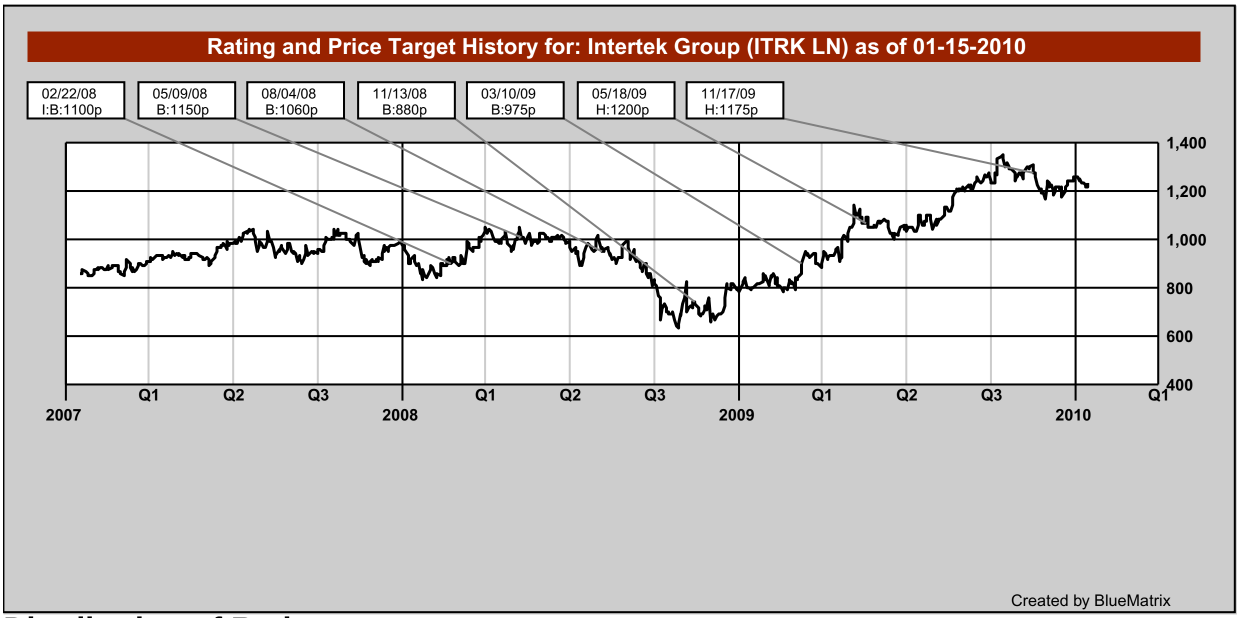

Distribution of Ratings

Rating	Count	Percent	IB Serv./Past 12 Mos. Count	IB Serv./Past 12 Mos. Percent
BUY [BUY/ SB]	470	53.00	45	9.57
HOLD [HOLD]	353	39.80	21	5.95
SELL [SU/ UNPF]	63	7.10	4	6.35

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