

17 Jan 2005

SGS

Very good results, new CEO to be announced soon

Recommendation

Buy

Price at 13 Jan 2005

CHF 815.50

Target Price

CHF 1000.00

Ticker/Code

SGSN.VX

Price Performance (%)



Relative Performance

1m	3.5%
3m	7.7%
12m	5.5%

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Year End	PBT			DB EPS		DB EPS	P/E	EV /	
31-Dec	Revenue	DB	Stated	New	Old	growth	(DB EPS)	EBITA	DPS
	CHFm	CHFm	CHFm	CHF	CHF	%	x	x	CHF
2004E	2,850	388	375	37.79	37.79	25.21	21.58	15.52	11.26
2005E	3,104	468	468	45.40	45.40	20.14	17.96	12.53	13.52
2006E	3,374	556	556	53.71	53.71	18.29	15.18	10.18	16.00

Source: Deutsche Bank Estimates and Company Data : "DB" means pre goodwill, non-recurring items

Shares Outstanding (Million):

8

Market Cap (million):

CHF 6,343.0

Local Index (.SPI):

4,236.00

52-week High/Low:

CHF 832 - 642

SGS reported a very good set of results with top line growth of 17.6% a 30.3% improvement at operating profit level and a 22.9% jump in net profit. We are very pleased to see further operating margin improvement and ...look forward to hearing the name of the next CEO over the next few weeks. Our forecasts and price target are unchanged.

SGS posted sales up 17.6% to CHF2,885m versus our forecast of CHF2,850m and consensus of CHF2,848m. Organic growth was a strong 10.7% for the full year versus our expectation of 10%. Organic growth rate accelerated to 11.3% in H2 after 10.1% in H1 (Europe 6.6%, Americas 12.7%, Asia 23.8%). Management stressed that growth in Asia does not relate only to the consumer division in China but to a broad range of countries and divisions. Net acquisitions represented CHF248m or 8.7% and currency played a slight negative role of 1.8%.

Operating income increased by 30.3% to CHF391m versus our forecast of CHF380m and consensus of CHF386m thanks to significant improvement in all divisions but Agricultural, Automotive, and System and Services Certification. FX rates played a 2.6% negative impact on group's operating profit.

Net profit was up 22.9% to CHF279m versus our forecast of CHF280m and consensus of CHF280m.

Free cash flow is up 34% to CHF225m despite a capex increase from CHF146m to CHF187m (We expected CHF180m, about 25% of the capex was spent in the strongly growing consumer testing business) and thanks to a decrease in working capital (CHF37m) -Remember in H1 a CHF54m increase had caused some concerns-. The group spent CHF201m on acquisitions versus our estimate of CHF216m, CHF15m on share buy-backs and CHF69m on dividends. Those numbers explain why the net cash position is down from CHF493m to CHF438m. Nothing wrong there.

External growth Johan Allegaert made it clear that there were no ongoing discussions with Bureau Veritas but that SGS view that consolidation

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would sooner or later occurred had not changed. On the other hand given the proliferation of smaller players, SGS is likely to continue undertaking smaller deals.

Outlook: Management confirms its commitment to deliver CHF45 per share in 2005 and the board will make an announcement regarding the CEO position in the coming weeks. Capex is expected to stay at last year's level and management is confident to achieve further improvement at working capital level. The board will propose a 33% increase in dividend to CHF12 per share at the AGM.

We review below the progress in each of the divisions:

Agriculture: Revenues grew by 6.3% to CHF257.1m (Organic growth 7.4%) and operating margin declined from 10.0% to 9.2%. H2 showed a strong recovery with a 14.4% increase in sales and a 10.5% operating margin. Operating profit for the full year was down 2.9% to CHF23.6m. This disappointing performance was due to unusual climatic conditions in H2 2003, which continued to affect negatively the performance in H1 2004 as well as start up investment in the development of new services. Cost saving measures put in place in Europe in 2004 will have a positive impact in 2005 and we are confident that the introduction of new services will generate additional growth in 2005.

Mineral Services: Revenues grew by 14.1% to CHF319.5m (Organic growth 16.4%) an impressive performance for a fairly mature business thanks to good growth in Russia, China, Brazil and India. Operating margin grew from 12.7% to 14.5% (14.2% in H1, 14.8% in H2) and operating profit was up 30.4% to CHF46.3m.

Oil, Gas & Chemicals Services: Revenues increased by 30.9% to CHF574.6m (Organic growth 12.8%), operating margin improved from 10.9% to 11.9% and operating profit was up 43.2% to CHF68.6m. Although organic growth was below last year 16.8%, SGS performance in Oil & Gas continues to be very impressive and the company gained further market share.

Life Science Services: Revenues grew by 80.2% to CHF106.5m (Organic decline -4.2%). Medisearch and Fresenius' acquisitions had a positive impact on sales. Operating margin grew from 10.0% to 12.0% (H2 2004 12.6% after 11.4% in H1) and operating profit was up 116.9% to CHF12m. Management still intends to grow the business through acquisitions but at that time is still operating a sub optimal business.

Consumer Testing services: Revenues grew by 32.4% to CHF360.6m (Organic growth 22.8%). Sales performance showed acceleration versus last year 14.2% organic growth and H2 organic growth of 26.0% was markedly above H1 19.3%. This confirms that the market is still booming in particular in Asia where SGS made substantial investments in laboratories and according to management new investments have now started to bear fruits. This also confirms that SGS is doing well versus Intertek. Remember Intertek H1 2004 organic growth rate at Labtest was 12.3%. Operating margin grew from 14.5% to 18.1% (H1 2004 17.3%, H2 2004 18.8%) and

operating profit was up 65.5% to CHF65.2m – now second largest contributor to group's operating profit. SGS operating margin in that business is still short of ITS 34% but is moving in the right direction despite heavy investments in the lab network. The lab network is currently running at below 80% production capacities and the business mixed is now 70% in testing, 30% in inspection. We expect further operating margin improvement in that business in 2005 and renewed double digit organic growth rate. A strategic alliance with Metlabs will help the E&E business in the US market which is opening up to other players than UL which was controlling the market so far.

Systems & Services Certification: Revenues grew by 2.5% to CHF235.4m (Organic growth 3.9%). The expected loss of revenues from the transition to the ISO 9000 in 2003 resulted in a larger than expected drop of renewal revenue. Corrected for this impact, organic growth stood at 10% last year. Restructuring measures negatively impacted profitability Operating margin declined from 15.1% to 13.0% (H1 2004 12.4%, H2 2004 13.4%). Operating profit was down 12.1% to CHF30.5m. Given the costs related to new product introduction and restructuring we are not concerned by the decline in operating margin.

Industrial Services: Revenues grew by an impressive 15.1% to CHF379.8m (Organic growth 15.2% for the full year and even 17.8% in H2). The bulk of the growth originated out of Western Europe and Asia. SGS' Chinese venture opened the first accredited building materials and construction laboratory in that country providing services to construction and engineering companies for new petrochemical and power generation plants and for infrastructure projects in China. Operating margin increased from 10.6% to 12.1% (H1 2004 11.5%, H2 2004 12.7%) and operating profit was up 32.1% to CHF46.1m.

Environmental Services: Revenues grew by 21.3% to CHF187.7m (Organic growth 9.3%). Operating margin increased from 6.5% to 8.1% (H1 2004 6.6%, H2 2004 9.3%) and operating profit was up 50.0% to CHF16.8m. The acquisition of Fresenius provides the division with a platform to enter the European soil and water testing market and is already bearing fruits.

Automotive: Revenues declined by 11.0% to CHF187.7m (Organic decline 14.0%). The decline in sales is due to a non-recurrence of the manufacturers' lease incentives for early return of vehicles in the US, which positively impacted volume in the first half of 2003. Operating margin increased from 9.9% to 10.7% (H1 2004 11.0%, H2 10.3%) and operating profit declined by 3.8% to CHF20.0m. The negative impact from the lease incentive program will disappear in 2005 and we also expect new projects to start contributing positively to top line growth. We continue to believe that the division is poised to enjoy double digit growth rate in the future. The company has won important contracts (Californian Bureau of Automotive Repairs to implement a data information system, statutory vehicle inspection in Chile,...). This clearly indicates that on one hand the brand is gaining traction and that on the other hand there is an increasing need for third party car inspection. There are opportunities for privatization schemes in 2005 in six states in the US, in Denmark, Brazil and some initiatives in India, China and Columbia.

Trade Assurance Services: Revenues grew by 16.4% to CHF255.4m (Organic growth 17.2%) mainly due to higher volume in Africa and South America. Operating margin increased from 20.5% to 24.1% (H1 2004 22.5%, H2 2004 25.8%) and operating profit was up 36.4% to CHF61.5m. We do view this growth rate as exceptional and expect a slow down in growth in 2005. However we would like to stress that the business model has now become much stronger with non PSI revenues representing now close to 50% of the division and growing in 2004 at a rate of about 40%.

Conclusion

The bear who had argued after H1 results that margin progression was unimpressive with H1 2004 operating margin at 13% versus 12.7% in H2 2003 will in our view have to revisit their judgement. SGS margin improved from 11.7% in H1 2003 to 13.0% in H1 2004 and from 12.7% in H2 2003 to 14.1% in H2 2004. This is impressive.

SGS organic growth was 10.7% for the full year and even 11.3% in H2. Headcount increased due to organic growth was only 5.9% -remember staff costs represent about 50% of sales-. We are convinced that SGS will continue to post significant organic growth this year and that operating leverage coupled with further efficiencies from six sigma will lead to further operating margin improvement.

Marchionne's departure and the absence of a permanent CEO does not seem to have had a negative impact on 2004's results and although we would have preferred to see an announcement today we trust the board that this is now a question of weeks and hence are confident that the good news is ahead of us. Our understanding is that the search process is over and that a candidate has been identified and the appointment is being finalized.

Finally although the 16% operating margin in 2005 will be in our view a tough target the company is on track to meet its EPS target of CHF45 and 10% organic growth -in our view what really matters is the EPS target-. We thought that the company may choose to release new medium term target last Friday but we understand that the new CEO has to put his mark on those new objectives. Our current forecasts of 45.4 per share in 2005 carries a 10.5% organic growth rate and a 14.8% operating margin. We do not account for new acquisitions which however are likely to occur. In 2004 we calculate that acquisitions added about 7% to our EPS or CH2 per share. A 16% operating margin would add around CHF4 per share to our 2005 forecasts.

SGS' only possible listed comparable is Intertek but although the two companies have similar business models they have a very different risk profile. Over 50% of Intertek's operating profit is coming from its highly profitable consumer business (Labtest division, 33% operating margin). Labtest is well-placed to benefit from the strong growth in consumer testing and verification but long term runs the risk of facing margin pressure. SGS on the other hand has a weaker positioning but should manage to increase its operating margin further from the current 18% level. In 2003 SGS shares traded at a 10% to 25% premium to Intertek

shares. In 2004, SGS has underperformed Intertek and SGS now trades at a 4% discount to Intertek 2005 consensus P/E rating.

Valuation and Risks

We expect EPS growth of 20% in 2005 and 18% in 2006 and longer term SGS should be able to grow EPS by 13% pa through a combination of internal (7-10%) and external (3-5%) growth. Our price target of CHF1000 implies a 2006 P/E of 18.6x in line with its historical valuation. Our DCF analysis indicates a value per share of CHF1,000, assuming a 3.6% long-term growth rate and a WACC of 8.7%. The main risks to our price target are a potential slowdown in international trade and ongoing market concerns about the current gap in management

	2002	%chg	1H 2003	%chg	2H 2003	2003	%chg	1H 2004	%chg	Organic	2H 2004	%chg	Org.	2004	%chg	Org.	2005e	
Revenues								1390.0			1495.0			2885.0			3139.9	
Agricultural	250.4	-1.6%	122.0	-2.6%	119.8	-4.3%	241.8	-3.4%	124.3	1.9%	1.0%	132.8	10.9%	14.4%	257.1	6.3%	7.4%	270.0
Minerals	268.3	28.2%	132.5	0.7%	147.4	7.8%	279.9	4.3%	150.7	13.7%	12.0%	168.8	14.5%	20.6%	319.5	14.1%	16.4%	341.9
Oil,Gas & Chemicals	398.8	-2.9%	212.0	4.4%	227.1	16.0%	439.1	10.1%	282.5	33.3%	12.6%	292.1	28.6%	13.1%	574.6	30.9%	12.8%	614.8
Consumer Testing	283.3	5.0%	126.4	-3.7%	145.9	-4.0%	272.3	-3.9%	165.6	31.0%	19.3%	195.0	33.7%	26.0%	360.6	32.4%	22.8%	414.7
Industrial	325.4	3.2%	158.7	2.1%	171.4	0.8%	330.1	1.4%	182.3	14.9%	12.5%	197.5	15.2%	17.8%	379.8	15.1%	15.2%	412.8
Automotive	211.3	3.4%	111.9	-10.6%	99.1	15.0%	211.0	-0.1%	89.0	-20.5%	-18.4%	98.7	-0.4%	-88.0%	187.7	-11.0%	-14.0%	221.5
SSC	208.1	3.5%	105.4	1.0%	124.3	19.9%	229.7	10.4%	114.2	8.3%	7.3%	121.2	-2.5%	0.9%	235.4	2.5%	3.9%	261.3
Trade Assurance	209.7	-22.5%	96.7	-16.9%	122.8	31.5%	219.5	4.7%	133.0	37.5%	37.8%	122.4	-0.3%	0.7%	255.4	16.4%	17.2%	268.2
Life sciences	57.1	-6.0%	29.6	-6.0%	29.5	15.2%	59.1	3.5%	50.9	72.0%	-4.8%	55.6	88.5%	-3.8%	106.5	80.2%	-4.2%	110.8
Environmental	179.5	-6.0%	78.5	1.6%	93.5	-8.5%	172.0	-4.2%	97.3	23.9%	10.7%	111.3	19.0%	7.8%	208.6	21.3%	9.3%	224.0
Total	2391.9	3%	1173.7		1280.8		2454.5		1389.8			1495.4	16.8%	11.3%	2885.2	17.5%	10.7%	3139.9
Operating profit								181.0			210.0			391.4			463.9	
Agricultural	24.5	37%	12.4	10.7%	11.9	-10.5%	24.3	-0.8%	9.7	-18.5%		13.9	16.8%		23.6	-2.9%	-3%	28.3
Minerals	27.5	42%	15.0	30.4%	20.5	28.1%	35.5	29.1%	21.4	4.4%		24.9	21.5%		46.3	30.4%	30%	51.3
Oil,Gas & Chemicals	31.1	-27%	23.2	52.6%	24.7	55.3%	47.9	54.0%	33.7	36.4%		34.9	41.3%		68.6	43.2%	43%	76.9
Consumer Testing	29.5	38%	17.7	90.3%	21.7	7.4%	39.4	33.6%	28.6	31.8%		36.6	68.7%		65.2	65.5%	65%	86.3
Industrial	39.1	4%	15.4	5.5%	19.5	-20.4%	34.9	-10.7%	21.0	7.7%		25.1	28.7%		46.1	32.1%	4%	53.7
Automotive	13.1		12.0	48.1%	8.8	76.0%	20.8	58.8%	9.8	11.4%		10.2	15.9%		20.0	-3.8%	-4%	28.8
SSC	23.8	15%	14.1	67.9%	20.6	33.8%	34.7	45.8%	14.2	-31.1%		16.3	-20.9%		30.5	-12.1%	15%	39.2
Trade Assurance	23.3	-32%	20.0	51.5%	25.1	148.5%	45.1	93.6%	29.9	19.1%		31.6	25.9%		61.5	36.4%	36%	62.8
Life sciences	3.7		2.9	52.6%	3.0	66.7%	5.9	59.5%	5.8	93.3%		7.0	133.3%		12.8	116.9%	117%	14.4
Environmental			4.2	20.0%	7.0		11.2		6.4	-8.6%		10.4	48.6%		16.8	50.0%	7%	22.4
Total	215.6	57%	136.9	41.1%	162.8	37.3%	299.7	39.0%	180.5	10.9%		210.9	29.5%		391.4	30.6%	31%	463.9
Operating margin																		
Agricultural	9.8%		10.2%		9.9%		10.0%		7.8%			10.5%		9.2%			10.5%	
Minerals	10.2%		11.3%		13.9%		12.7%		14.2%			14.8%		14.5%			15.0%	
Oil,Gas & Chemicals	7.8%		10.9%		10.9%		10.9%		11.9%			11.9%		11.9%			12.5%	
Consumer Testing	10.4%		14.0%		14.9%		14.5%		17.3%			18.8%		18.1%			20.8%	
Industrial	12.0%		9.7%		11.4%		10.6%		11.5%			12.7%		12.1%			13.0%	
Automotive	6.2%		10.7%		8.9%		9.9%		11.0%			10.3%		10.7%			13.0%	
SSC	11.4%		13.4%		16.6%		15.1%		12.4%			13.4%		13.0%			15.0%	
Trade Assurance	11.1%		20.7%		20.4%		20.5%		22.5%			25.8%		24.1%			23.4%	
Life sciences	6.5%		9.8%		10.2%		10.0%		11.4%			12.6%		12.0%			13.0%	
Environmental	0.0%		5.4%		7.5%		6.5%		6.6%			9.3%		8.1%			10.0%	
Total	9.0%		11.7%		12.7%		12.2%		13.0%			14.1%		13.6%			14.8%	

Source: SGS, DB estimates

Appendix 1

Important Disclosures

Additional information available upon request

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SGS	SGSN	805	6,8,13,14

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Pascal Moura

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