COMPANY NOTE

Target | Estimate Change

CHE | Industrials | Industrial Services

18 July 2011

Jefferies

EQUITY RESEARCH EUROPE

SGS (SGSN VX)
Safe Haven Blues

HOLD
Price target CHF1,500.00
(from CHF1,600.00)
Price CHF1,470.00

Key Takeaway

SGS's H1 update pointed to strong underlying trends across the business and also to good progress on the investment program. However, valuation continues to look stretched after currency adjustments. Hold reiterated.

Where did it break down? Currency stole the H1 show, upsetting conventional wisdom that testing players face little transactional risk. While the bulk of the business was reasonably well hedged naturally (there was only limited transaction impact in the 'Western' businesses), the 40bps FX driven margin erosion appears to have been driven by a long tail of smaller currencies that moved uniformly against the Franc and in which SGS does not have a natural hedge and cannot put derivatives in place. We would expect more of the same in H2 and into 2011 and have marked down our H2 margin forecast by 40bps due to the currency issue. However, we expect the currency mismatch to eventually fade to a historical footnote as the exceptional move in the Franc moderates.

But the core healthy. Moving beyond the currency shock, underlying trends in the business were generally strong. Organic growth of 9.7% was nicely ahead of our 8% forecast, was broadly based, and accelerated in May/June. Organic margin expansion of 40bps was in line with our forecast, with only a few slip-ups and generally encouraging signs that conditions should improve through H2.

Investment program on track. Investments towards the 2014 plan were generally on track in H1. Management expressed mild frustration that things cannot move more quickly, but was comfortable that the pieces are being put in place to hit the LT targets (ex-FX). The program diluted H1 margin by 50bps, slightly higher than our forecast, but on lower capex than we had estimated. Looking ahead, we would expect modestly more investment related margin dilution in H2 before easing in 2012.

Valuation/Risks

We have adjusted our estimates to reflect the H1 update, modestly increasing our organic growth forecasts (to 9.5% for the FY), but significantly raising our forecast for currency headwinds in H2 and 2012. As a result, our EPS estimates for 2011/12 fall by 6% and our target price is reduced to CHF1,500. Our target continues to be derived by applying a 13x EV/EBIT multiple to our forward 12 month EBIT forecast. Beyond further Swiss Franc strength, the key risk is the overhang of the investment program and potential duds.

CHF	*Prev.*	2010A	*Prev.*	2011E	*Prev.*	2012E	*Prev.*	2013E
Rev. (MM)	--	4,757.0	*4,817.6*	4,779.5	*5,382.4*	5,292.5	*6,054.9*	5,954.7
EBITDA (MM)	--	1,061.0	*1,070.5*	1,020.3	*1,233.4*	1,142.9	*1,435.7*	1,334.7
EBIT (MM)	--	836.0	*835.6*	800.0	*954.2*	902.3	*1,104.6*	1,044.0
Net Profit	--	588.0	*576.1*	545.0	*659.2*	617.4	*764.2*	715.7
EPS								
FY Dec	--	77.64	*76.09*	71.98	*87.06*	81.54	*100.94*	94.53
FY P/E		18.9x		20.4x		18.0x		15.6x

Financial Summary

Net Debt (MM):	CHF(31.0)
Net Debt/Capital:	(20.0)%
Dividend Yield:	4.5%

Market Data

52 Week Range:	CHF1,724.00 - CHF1,375.09
Total Entprs. Value (MM):	CHF11,435.0
Market Cap. (MM):	CHF11,466.0
Insider Ownership:	20.6%
Institutional Ownership:	54.3%
Shares Out. (MM):	7.8
Float (MM):	4.3
Avg. Daily Vol.:	14,389

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Price Performance

Other Highlights

Other highlights from the H1 results and discussions with management that followed included more colour on the consumer/minerals/pharma businesses and on M&A.

Consumer concerns overdone

SGS also seems to have won some market share – partly at BV's expense

The consumer segment was naturally a focus of the investor meeting given challenges highlighted by BV and ITRK through their mid semester updates. SGS reported H1 LFL growth in consumer of 8.5% and an 110bps fall in adjusted margin y/y. The division saw fairly broad-based growth, both globally and also across the softline/hardline segments. SGS also appears to have won some market share -- which looks like it was partly at BV's expense. Margin dilution over the period was largely driven by a shift in mix (with high margin ROHS business slowly falling away in favour of other programs) and also partly the slow start to the year due to the well publicized longer Chinese New Year.

SGS does not see structural changes afoot in consumer

Looking ahead, SGS did point to a healthier close to the half, good early H2 trends, and generally a business as usual environment. Numerous questions on the group's conference call betrayed significant market concerns around structural changes in consumer, which SGS does not subscribe to. The company again suggested wage inflation and production migration in China are manageable and is seeing no notable change in the competitive environment.

Minerals to remain the driver

The minerals division was the positive highlight of the H1 figures, growing 23.9% LFL and posting a 250bps margin improvement (ex-FX). SGS noted very strong trends in metallurgy, firming trends in geochemistry, and modest growth in the trade inspection business. Pricing in general is now very good, with SGS stretched on capacity and expanding facilities aggressively, and seeing some gazumping.

Looking forward, we believe the minerals division can continue to lead SGS on growth and margin progression given healthy industry capex trends and potential for futher pricing improvements. We have upped both our growth and margin forecasts for H2 and 2012.

Pharma a longer fix

Despite healthy H1 growth in the life science segment, margin was under pressure, particularly in the clinical business where SGS saw significant empty capacity in its Paris centre. While we expect general CRO trends globally to continue to gradually improve, SGS did not point to improved near term bookings in Paris and we would expect the division to weigh on results through H2.

While management did make a case for synergies between its discovery/QC operations and a clinical business, we continue to have doubts on the utility of hanging on to an undersized clinical presence over the longer term.

M&A finally coming?

M&A has been slightly disappointing thus far in 2011 despite numerous signs management is becoming more aggressive. The company pointed to a number of very near term acquisitions and generally to a business as usual M&A environment, with still high multiples, but a full pipeline.

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Valuation the sticking point

Despite the strong pull-back in the shares on Friday, SGS remains on a premium valuation to its testing peers. Expected near term M&A could erode some of that premium, but we see no justification for a premium valuation to peers given newfound currency risk, uncertainty around the 2014 investment plan, and overhang from the Von Finck holding (15%).

Chart 1: Testing Comparables

Company	Ticker	Rating	Price	Mkt cap	EV/Sales			EV/EBITDA			EV/EBIT			P/E			'09-'13
				(€m)	2010	2011E	2012E	2010	2011E	2012E	2010	2011E	2012E	2010	2011E	2012E	EPS CAGR
Bureau Veritas	BVI FP	Hold	57.20	6,250	2.1	2.2	1.9	11.3	11.4	10.1	13.6	13.8	12.0	17.5	18.7	16.3	15%
Campbell Brothers	CPB AU	NC	45.00	2,284	3.0	2.5	2.1	14.4	8.7	7.5	17.7	12.8	10.1	22.1	17.9	14.9	19%
Eurofins Scientific AG	ERF FP	Buy	64.22	919	1.3	1.6	1.4	9.2	9.3	7.4	17.7	15.1	11.2	33.2	24.4	16.2	43%
Intertek Group PLC	ITRK LN	Buy	1,920	3,505	1.9	1.9	1.9	10.4	11.8	9.5	13.0	15.1	11.5	19.5	19.6	16.4	20%
Mistras Group	MG US	NC	16.47	310	1.5	1.3	1.1	10.5	8.3	7.0	18.4	14.0	10.5	41.9	24.6	18.8	n/a
SGS	SGSN VX	Hold	1,470	9,966	2.4	2.3	2.1	10.6	10.9	9.7	13.4	13.9	12.3	19.6	20.4	18.0	7%
AVERAGE - BV, ITRK, SGS					**2.1**	**2.1**	**2.0**	**10.8**	**11.4**	**9.8**	**13.3**	**14.3**	**12.0**	**18.9**	**19.6**	**16.9**	**14%**
AVERAGE					**2.0**	**2.0**	**1.7**	**11.1**	**10.1**	**8.5**	**15.6**	**14.1**	**11.3**	**25.6**	**20.9**	**16.8**	**21%**

* All estimates except CPB AU and MG US are Jefferies figures. CPB AU and MG US are Bloomberg estimates.

Source: Company Documents, Jefferies International Limited

On an absolute basis, we also have trouble seeing upside from here. SGS is currently trading on 13x forward EV/EBIT – right in line with average levels seen through the previous cycle. While we believe some of the market fears regarding a structural testing slowdown are overblown (in consumer particularly), we nevertheless believe the sector is starting to show its age and doesn't deserve to trade above the levels of the previous cycle.

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Chart 2: SGS Results Analysis

	H1 '10 Actual	H1 '11 Actual	H1 '11 Jef Est.	
Revenues	**2,352**	**2,345**	**2,340**	
% Growth	1.0%	-0.3%	-0.5%	
LFL Growth (%)	*1.0%*	*9.7%*	*8.0%*	Only modest slowing from 2010 exit and healthier May/June.
Perimeter Effect (%)	*0.7%*	*3.1%*	*2.3%*	Largely driven by ITV acquisition.
Currency Impact (%)	*-0.7%*	*-13.1%*	*-10.8%*	CHF strong vs. every major global currency.
Operating Profit	**388**	**374**	**392**	
Operating Margin	16.5%	16.0%	16.7%	-40bps due to currency, -50bps due to investment program, +30 organic.
Net Profit	**270**	**246**	**268**	
EPS	**35.67**	**32.30**	**35.33**	Slighter higher tax rate than expected.

	H1 '10 Actual	H1 '11 Actual	H1 '11 Jefco Est.	
Agricultural Services				
Sales	170.2	155.8	169.6	Good growth in inland and better Q2 in trade. Russia/Ukraine export bans weigh on
LFL Growth (%)	*-3.1%*	*2.6%*	*5.0%*	trade. Low volumes in SE Europe.
Operating Profit	22.6	21.4	24.6	Improved margin (+110bps ex-FX), but on very easy base.
Operating Margin	*13.3%*	*13.7%*	*14.5%*	Expect better H2 as export bans now cancelled and grain has to move.
Minerals Services				
Sales	291.1	323.2	322.0	Metallurgical and geochem labs working at or close to full capacity. Trade inspection
LFL Growth (%)	*5.6%*	*24.6%*	*17.0%*	relatively strong. Trends continued to improve through half.
Operating Profit	51.4	59.4	62.8	Margin strength (+150bps ex-FX) due to pricing and capacity utilization.
Operating Margin	*17.7%*	*18.4%*	*19.5%*	Expect strong H2 as pricing continues to firm and new capacity comes on stream.
Oil, Gas & Chemical Services				
Sales	480.2	451.0	451.9	Trade inspection strong. Plant and terminal operations grow well. Cargo treatment
LFL Growth (%)	*3.8%*	*6.9%*	*7.0%*	volumes down due to dislocated resources (Turkey/Russia refining issue).
Operating Profit	65.1	58.8	62.8	Some margin compression (-20bps ex-FX) due to upstream investments.
Operating Margin	*13.6%*	*13.0%*	*13.9%*	Expect healthy H2, but some issues on shift in refinery ownership in Europe.
Life Sciences Services				
Sales	98.0	99.5	104.4	QC and R&D demand strong. Early phase clinical research weak (notable in Paris
LFL Growth (%)	*1.2%*	*7.2%*	*6.0%*	clinic).
Operating Profit	12.7	10.3	13.4	Margin decline reflects weak clinical demand and investments.
Operating Margin	*13.0%*	*10.4%*	*12.8%*	Expect still tough H2 as pipeline for Paris not promising.
Consumer Testing Services				
Sales	407.3	387.5	378.3	Good sample volumes, including in softlines and hardlines and newer businesses -
LFL Growth (%)	*5.6%*	*8.5%*	*6.0%*	food/photovoltaic. Still some lingering slowing on ageing of CPSIA.
Operating Profit	102.3	91.4	92.7	Margin decline (-110bps ex-FX) reflects investments and weaker mix (ex-CPSIA/ROHS).
Operating Margin	*25.1%*	*23.6%*	*24.5%*	Expect healthy H2.
Systems & Services Certification				
Sales	188.5	177.4	181.1	
LFL Growth (%)	*7.8%*	*5.8%*	*8.0%*	Strong emerging markets growth, mature markets weaker (particularly Japan post earthquake).
Operating Profit	36.3	30.8	34.4	Margin dilution reflects Japan and weak Portugal/Spain.
Operating Margin	*19.3%*	*17.4%*	*19.0%*	
Industrial Services				
Sales	368.2	368.7	357.8	Strong emerging markets demand - both in infrastructure and energy.
LFL Growth (%)	*-3.3%*	*10.6%*	*6.0%*	Margin decline reflects weak Spanish demand (still ~20% of revenues), slow Middle
Operating Profit	46.3	39.8	45.8	East and investment ramp.
Operating Margin	*12.6%*	*10.8%*	*12.8%*	Expect better H2 as investments come on line - although Spain to still weigh on result.
Environmental Services				
Sales	136.5	140.2	134.4	
LFL Growth (%)	*-4.4%*	*14.6%*	*7.0%*	Europe mixed, with strong Germany/Belgium, but weaker France (aggressive
Operating Profit	12.5	12.0	12.3	competition from smaller players) and Southern Europe. Emerging markets strong.
Operating Margin	*9.2%*	*8.6%*	*9.2%*	Margin dilution reflects investments and weak U.S.
Automotive Services				
Sales	99.9	136.6	130.4	
LFL Growth (%)	*-25.0%*	*6.9%*	*10.0%*	Statutory inspection business performed well, despite civil unrest in North Africa.
Operating Profit	19.1	28.8	23.9	Margin benefits from ITV acquisition and better non-statutory performance. U.S./Japan
Operating Margin	*19.1%*	*21.1%*	*18.3%*	margins weaker due to supply chain disruptions.
Governments & Institutions Services				
Sales	111.9	104.7	109.7	
LFL Growth (%)	*10.6%*	*3.1%*	*8.0%*	Good PCA demand generally, but lost contract in Mexico and Ivory Coast disruptions.
Operating Profit	19.5	21.7	19.1	PSI programs performed well.
Operating Margin	*17.4%*	*20.7%*	*17.4%*	

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Chart 3: Key Data

December year end	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011E	2012E	2013E
Income Statement (CHFm)												
Turnover	2392.0	2454.0	2885.0	3308.0	3821.0	4372.0	4818.0	4712.0	4757.0	4779.5	5292.5	5954.7
% change	2.6%	2.6%	17.6%	14.7%	15.5%	14.4%	10.2%	-2.2%	1.0%	0.5%	10.7%	12.5%
EBITDA	311.0	396.0	508.0	642.0	800.0	908.0	1024.0	1022.0	1061.0	1020.3	1142.9	1334.7
margin %	13.0%	16.1%	17.6%	19.4%	20.9%	20.8%	21.3%	21.7%	22.3%	21.3%	21.6%	22.4%
EBIT	127.0	293.0	380.0	502.0	623.8	690.0	937.0	794.0	836.0	800.0	902.3	1044.0
margin %	5.3%	11.9%	13.2%	15.2%	16.3%	15.8%	19.4%	16.9%	17.6%	16.7%	17.0%	17.5%
Pre-Tax	140.0	303.0	386.0	507.0	622.8	692.0	933.0	791.0	829.0	776.0	880.2	1021.8
Net income	109.0	227.0	278.0	371.0	442.8	500.0	692.0	566.0	588.0	545.0	617.4	715.7
margin %	4.6%	9.3%	9.6%	11.2%	11.6%	11.4%	14.4%	12.0%	12.4%	11.4%	11.7%	12.0%
Balance Sheet (CHFm	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011E**	**2012E**	**2013E**
Working Capital	216.0	196.0	139.0	223.0	252.0	256.0	274.0	224.0	208.0	200.8	222.4	250.2
WC as a % of turnover	9.0%	8.0%	4.8%	6.7%	6.6%	5.9%	5.7%	4.8%	4.4%	4.2%	4.2%	4.2%
Capital Employed	1317.0	1404.0	1561.0	1994.0	1980.0	2337.0	2558.0	2773.0	2998.0	3549.8	3842.6	4191.4
Net Debt	-402.0	-493.0	-438.0	-430.0	-215.0	-378.0	-248.0	-476.0	-259.0	-31.0	-3.6	-29.7
Gearing	-44.8%	-46.0%	-37.7%	-29.9%	-13.8%	-19.5%	-13.6%	-23.0%	-12.5%	-1.6%	-0.2%	-1.2%
Cash Flow (CHFm)	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011E**	**2012E**	**2013E**
Cash Flow	219.0	395.0	486.0	598.0	582.8	694.0	802.0	827.0	816.0	777.1	887.6	1040.8
Capex	-121.0	-171.0	-201.0	-205.0	-224.0	-271.0	-278.0	-209.0	-250.0	-316.6	-370.5	-387.1
WCR	32.0	-70.0	-61.0	-187.0	-31.0	12.0	-22.0	13.0	-33.0	-44.8	-21.6	-27.8
Free-Cash Flow	130.0	154.0	224.0	206.0	327.8	435.0	502.0	631.0	533.0	415.7	495.5	625.9
Key Valuation Ratios	**2002**	**2003**	**2004**	**2005**	**2006**	**2007**	**2008**	**2009**	**2010**	**2011E**	**2012E**	**2013E**
Shares Outstanding (m)	7.8	7.7	7.5	7.6	7.6	7.6	7.6	7.5	7.6	7.6	7.6	7.6
Stock Price (CHF)	388.5	604.0	720.5	956.0	1,226	1,452	1,250	1,197	1,518	1,470	1,470	1,470
Market Cap*	3,020	4,644	5,396	7,260	9,307	11,085	9,496	8,975	11,493	11,129	11,129	11,129
EPS net	14.02	29.52	37.12	48.85	58.33	65.47	76.19	75.48	77.64	71.98	81.54	94.53
PER net	27.7	20.5	19.4	19.6	21.0	22.2	16.4	15.9	19.6	20.4	18.0	15.6
CFPS	28.2	51.4	64.9	78.7	76.8	90.9	105.6	110.3	107.8	102.6	117.2	137.5
PCF	13.8	11.8	11.1	12.1	16.0	16.0	11.8	10.9	14.1	14.3	12.5	10.7
P/NAV	3.4	4.3	4.6	5.0	6.0	5.7	5.2	4.3	5.6	5.8	5.1	4.4
ROCE	9.2%	21.5%	25.6%	28.2%	31.4%	32.0%	33.1%	29.8%	29.0%	24.4%	24.4%	26.0%
ROE	12.6%	21.9%	25.2%	27.0%	29.9%	26.8%	39.1%	28.5%	29.7%	29.6%	29.5%	30.0%
EV	2,618	4,151	4,958	6,830	9,092	10,707	9,248	8,499	11,234	11,098	11,126	11,100
EV / Sales	1.1	1.7	1.7	2.1	2.4	2.4	1.9	1.8	2.4	2.3	2.1	1.9
EV / EBITDA	8.4	10.5	9.8	10.6	11.4	11.8	9.0	8.3	10.6	10.9	9.7	8.3
EV / EBIT	20.6	14.2	13.0	13.6	14.6	15.5	9.9	10.7	13.4	13.9	12.3	10.6
Yield %	1.6%	1.2%	1.3%	1.2%	4.2%	1.6%	2.8%	4.2%	4.2%	4.5%	3.2%	3.6%

Source: Company Documents, Jefferies International Limited

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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 analyzes 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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Other Companies Mentioned in This Report

- Bureau Veritas (BVI FP: €57.20, HOLD)
- Eurofins Scientific (ERF FP: €64.22, BUY)
- Intertek Group (ITRK LN: p1,920.00, BUY)

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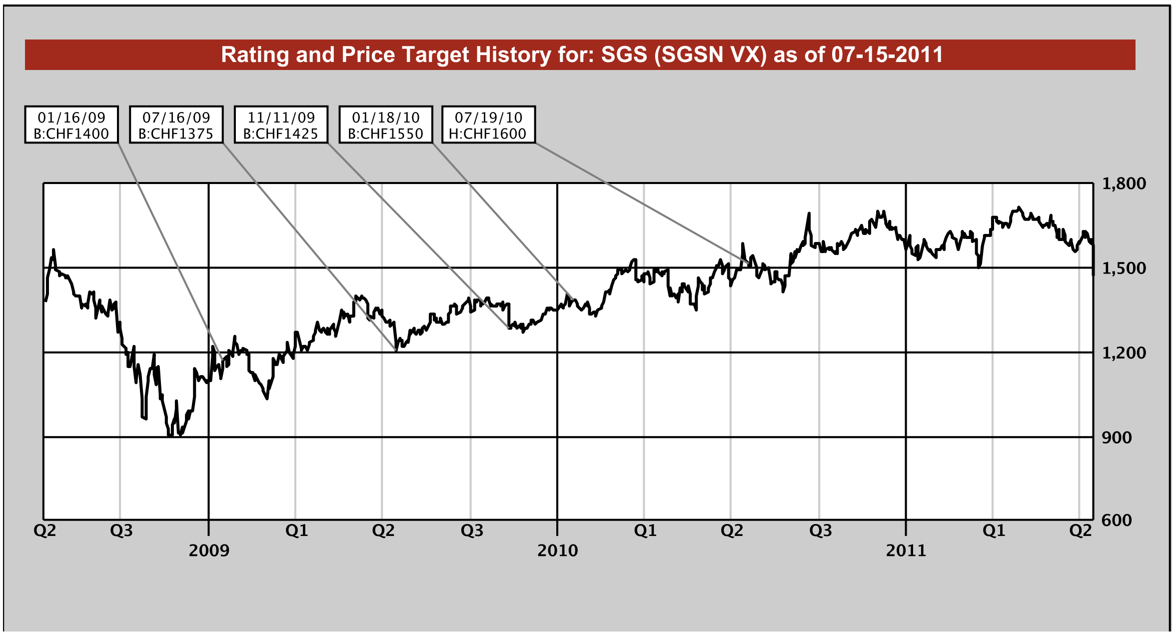

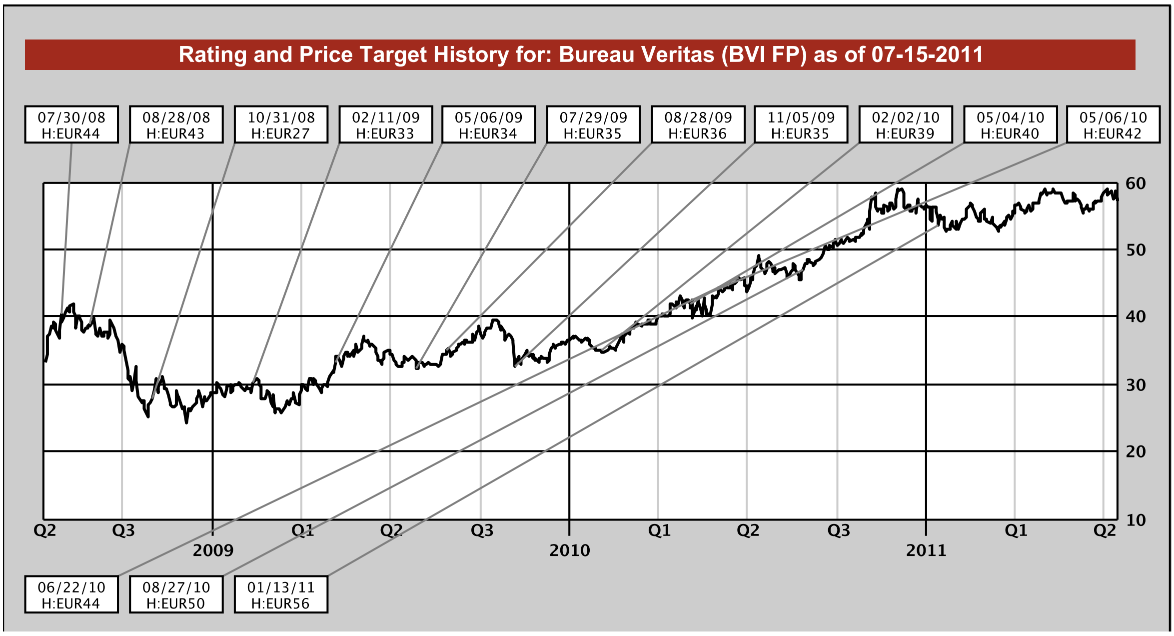

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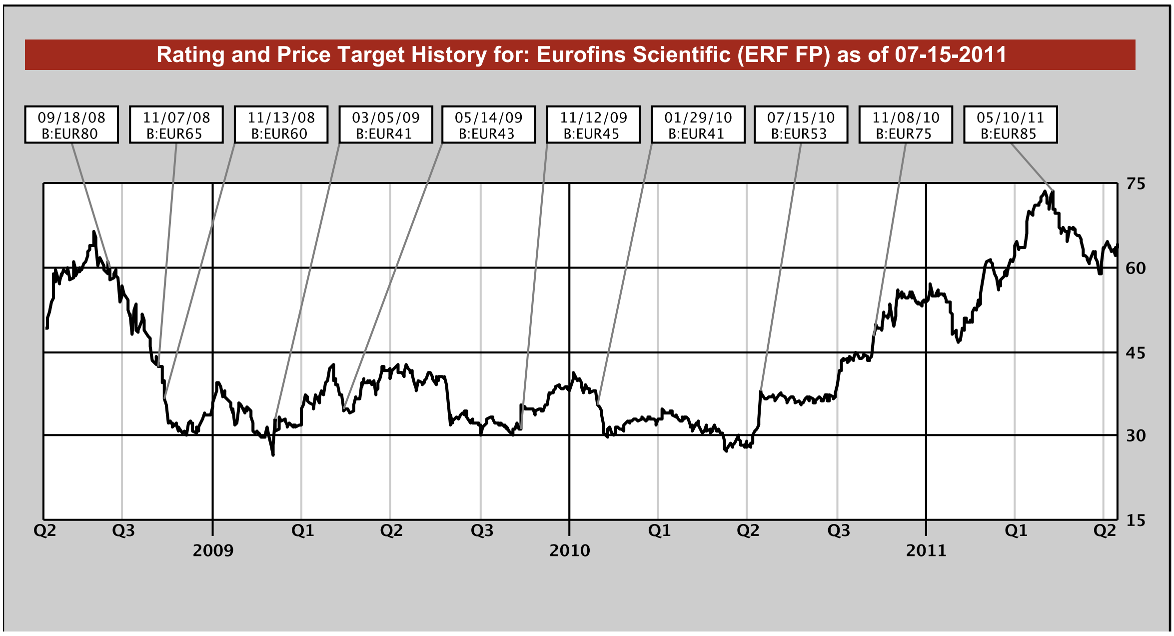

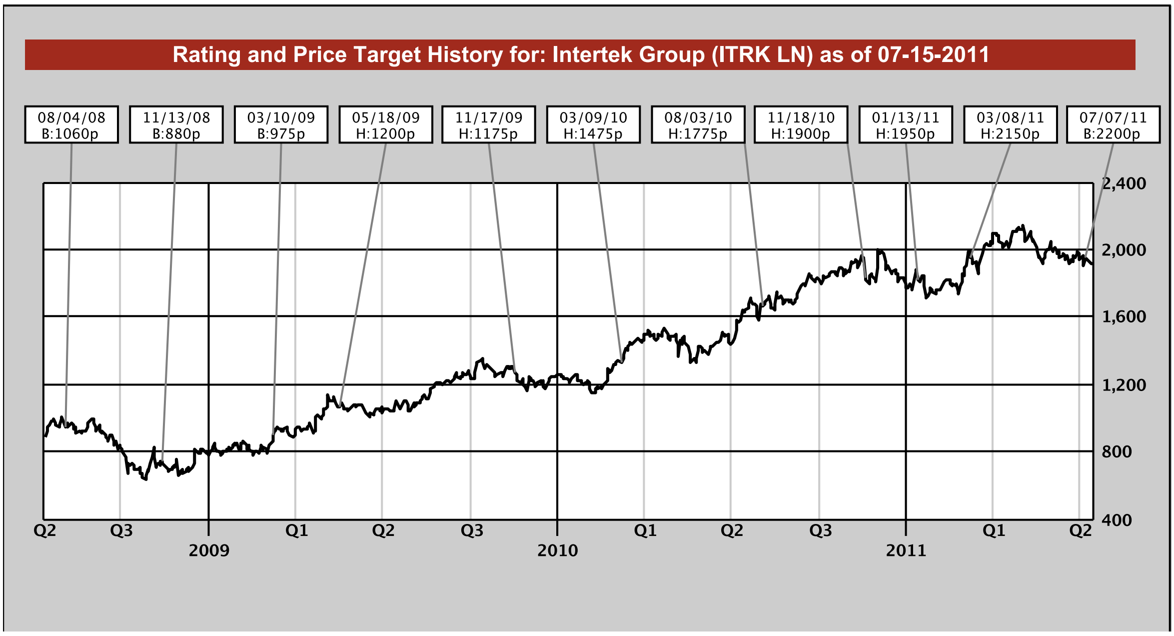

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Rating	Count	Percent	IB Serv./Past 12 Mos. Count	IB Serv./Past 12 Mos. Percent
BUY	661	53.30%	41	6.20%
HOLD	514	41.40%	26	5.06%
UNDERPERFORM	66	5.30%	3	4.55%

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