

Services Group  
Diversified Commercial

Switzerland

**SGS (VX: SGSN VX)**

**Another Buying Opportunity? We Think So**

**Company Update  
Estimate Change**

Rating: BUY  
Price: CHF1,088.00  
Price Target: CHF1,450.00  
Bloomberg: **VX: SGSN VX**

**Market Data**

52-Week Range: CHF1,348.58-CHF886.60  
Total Entprs. Value (MM): CHF8,347.2  
Market Cap. (MM): CHF8,508.2  
Shares Out. (MM): 7.82  
Float (%): 53.0%  
Avg. Daily Vol.: 21,654

**Financial Summary**

Net Debt (MM): (CHF161.00)  
Net Debt/Capital: (9%)

CHF	2005A	2006E	2007E	2008E
<b>Rev. (MM)</b>	<b>3308.0</b>	<b>3829.0</b>	<b>4295.0</b>	<b>4795.0</b>
Prev.	--	3808.0	4265.0	4755.0
<b>EV/Rev.</b>	<b>2.5x</b>	<b>2.2x</b>	<b>1.9x</b>	<b>1.7x</b>
<b>EBITDA (MM)</b>	<b>642.0</b>	<b>786.0</b>	<b>883.0</b>	<b>1,000.0</b>
Prev.	--	--	902.0	1,015.0
<b>EV/EBITDA</b>	<b>13.0x</b>	<b>10.6x</b>	<b>9.5x</b>	<b>8.3x</b>
<b>EPS</b>				
<b>FY Dec</b>	<b>48.90</b>	<b>58.90</b>	<b>67.50</b>	<b>77.60</b>
Prev. FY	--	58.80	68.80	78.40
<b>FY P/E</b>	<b>22.2x</b>	<b>18.5x</b>	<b>16.1x</b>	<b>14.0x</b>
<b>EBIT (MM)</b>	<b>502.0</b>	<b>620.0</b>	<b>702.0</b>	<b>802.0</b>
Prev.	--	611.0	711.0	809.0
<b>EV/EBIT</b>	<b>16.6x</b>	<b>13.5x</b>	<b>11.9x</b>	<b>10.4x</b>
<b>Net Profit</b>	<b>371.0</b>	<b>446.0</b>	<b>511.0</b>	<b>588.0</b>
Prev.	--	447.0	522.0	596.0
<b>Consensus</b>	<b>48.90</b>	<b>58.10</b>	<b>66.50</b>	<b>73.30</b>

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**Investment Summary**

Despite what we thought were generally good 1H 2006 results, SGS's share price was punished, closing down 4%. We believe this is an over-reaction to poor figures from the TAS division (representing just 4.5% of sales), and has created a good buying opportunity in a quality growth story.

**Event**

SGS published its 1H 2006 results, with sales beating expectations, although EBIT was only in line and EPS was a touch light. Sales grew 18.5% (10.4% organic) to CHF1,845m, EBIT (pre-exceptionals) grew 23% to CHF281m and EPS (pre-exceptionals) grew 15.3% to CHF26.5. Buy rating and CHF1,450 PT maintained.

**Key Points**

**Good, Though Not Exceptional.** We would characterize SGS's results as good, though not exceptional. Sales came in ahead of expectations, but EBIT (pre-exceptional items relating to asset sales) was only in line and EPS were actually slightly light due to higher financial expenses and higher minorities. SGS also reaffirmed its expectation of a good 2H 2006 as well as its 2008 targets of CHF5bn in sales, operating margins of 17% and EPS of CHF80.

**Sales Very Strong.** Sales growth was impressive in our opinion, driven by strong performances from the Minerals, OGC (Oil, Gas & Chemicals) and Consumer Testing divisions. Revenues grew 18.5% to CHF1,845m, beating our CHF1,821m estimate and consensus of CHF1,797m. Organic growth of 10.4% was bang in line with our estimate, external growth added 4.3% and the currency impact was a positive 3.8%.

**EBIT Boosted By Exceptional Income.** SGS reported EBIT growth of 28.5% to CHF302m for an operating margin of 16.4%. However, this included CHF21m of net exceptional income relating mainly to gains from the sale of assets during the period. Excluding these items, core EBIT grew 23% to CHF281m, which was slightly below our estimate of CHF287m but in line with consensus of CHF280m. This equates to a margin of 15.3% versus our 15.7% estimate. Margins were impacted by start-up and restructuring costs in the Environmental Services and Life Sciences divisions. Adjusting for these costs we believe margins would have been around 15.5%-15.6%.

**EPS Slightly Light.** At the bottom line, EPS pre-exceptionals grew 15.3% to CHF26.5 versus our CHF27.6 estimate, due to lower EBIT, higher financial expenses and higher minorities. Including the exceptional items, EPS grew 22.6% to CHF28.5. We have nudged up our sales estimate for 2006, but kept our EPS estimate essentially unchanged, reflecting the slightly lower margins and items below the EBIT line.

**Valuation/Risks**

SGS currently trades on 18.5x our 2006 EPS estimate of CHF 58.9 and 16.1x our 2007 EPS estimate of CHF 67.5. Our 12-month price target of CHF1,450 is based on 21x our 2007 EPS estimate, justified in our view by SGS's strong balance sheet, rising margins and a 17% 3-year forward EPS CAGR.

**Impact on Other Companies**

Wendel Investissement (MF FP-€87.65, Buy) could be impacted through its holding of Bureau Veritas, a key competitor to SGS.

**Strength Came From the Consumer, Minerals and OGC Businesses**

- The Consumer Testing division enjoyed impressive organic growth of 27.1% in the first half, well ahead of our 20% estimate. While continuing to be driven by growth in Asia, the division also benefited from a standards change for hazardous substances implemented during the period. In terms of margins, SGS also noted better capacity utilization in its electronic equipment and chemical testing labs.
- The Oil, Gas & Chemicals (OGC) division grew organically by 13.4%, slightly below our forecast of 15%, but at the same time saw margins increase to 13.9% versus 12.2% in 1H 2005, which was well ahead of our forecast of 13%. Revenues in the division continue to benefit from high commodity prices and consequent increases in trade and testing demand. Margins benefited from good capacity utilization and the migration to newer higher value-added (non-inspection) services such as logistics consulting and lab outsourcing. Minerals Services also performed well, with organic growth coming in at 18.1% for the period.

**Life Sciences, Environmental, and Trade Assurance Were Weak**

- The Life Sciences services division saw an organic decline in revenue of 1.8% and margin erosion to 12.1% in 1H 2006 from 14.2% in 1H 2005. Organic revenue growth and margins were negatively impacted by the absorption of major acquisitions (primarily aster.cephac), as well as by the rationalization of labs in Europe and start-up costs related to new laboratory infrastructure in Asia. The company noted the longer lag before profitability on greenfield operations in the life sciences field as a result of needs for local accreditation and GMP auditing, and we have reduced our margin estimates accordingly.
- The Environmental Services division grew organically at a rate roughly in line with our estimates (6.9% vs. our 7.5% estimate), but margins eroded to 9% from 9.9% in 1H 2005. SGS cited weakness due to weather conditions in Europe, a slow roll-out of regulatory changes in Italy and laboratory rationalization costs, but noted that second half margins should show a significant improvement.
- Trade Assurance Services revenues were down significantly in the half with a decline of 30.7% vs. our estimate of a 10% decline. Margins also collapsed from 21% to 13.7% yoy. The decline was due to the termination of Venezuelan and Nigerian pre-shipment inspection (PSI) contracts which was known by the market but had a worse than expected impact. SGS has increasingly migrated business in this division to non-PSI contracts and expects a recovery in margins going forward with the rationalization of the division's cost base. We believe that there has been a disproportionate focus on this division, which now represents just 4.5% of group sales, and which in our opinion has the worst declines now behind it.

**Acquisitions Continue, and Pipeline is Rich**

Together with organic growth, SGS continues to bolt on smaller acquisitions to complement both its geographic coverage and product offerings. Over the course of 1H 2006 acquisitions included:

- Cotax, a North Sea based testing company servicing the oil & gas sector with annualized revenues of ~CHF2m.
- Laroute, which supplies additive services to the oil industry and had 2005 revenue of CHF28m.
- aster.cephac, a French based provider of early stage clinical trial services which had revenue of CHF55m in 2005.
- Northview Biosciences, which provides quality control services to the pharmaceutical industry from two laboratories in the U.S. Northview's revenues in 2005 were CHF13m.

Partially offsetting the acquisitions were the company's disposals of Pink Healthcare Services and a Canadian consulting firm. The sale of the two businesses generated an exceptional CHF36m gain in the period (which was partially offset by legal claims of CHF6m and restructuring costs of CHF9m). The company continues to guide to 5% annual growth due to acquisitions (we currently estimate 3.7% for 2006) and highlighted a potential near-term acquisition in the energy infrastructure segment. In the longer term management continues to look at acquisitions in the software testing market, and it also commented that the acquisition pipeline remained rich given the fragmented nature of the market.

**Balance Sheet Still Healthy**

While net cash declined to CHF46m versus CHF349m in the year-ago period, this is primarily due to the payment of an exceptional dividend in the first half of CHF383m. Cash flow from operations was CHF214m, up 52% yoy but slightly below our estimate due to higher working capital requirements. Capex was CHF104m, in line with our estimate, and the total cost of acquisitions net of disposals in the quarter was CHF139m. We estimate that SGS will finish the year with net cash of CHF161m.

Growth Analysis	H1 05	H2 05	FY 05	H1 06	H1 06 - Jef. Est.
	Perimeter Effect %	2.2%	1.5%	1.8%	4.3%
Currency effect %	-1.5%	4.1%	1.4%	3.8%	2.3%
LFL %	11.3%	11.5%	11.4%	10.4%	10.5%
<b>Total (%)</b>	<b>12.0%</b>	<b>17.1%</b>	<b>14.6%</b>	<b>18.5%</b>	<b>16.9%</b>

Revenue - by Division	H1 05	H2 05	FY 05	H1 06	H1 06 - Jef. Est.
	Agricultural Services	137.8	157.0	294.8	156.7
% LFL Growth	11.0%	12.7%	11.8%	9.3%	8.0%
Minerals Services	176.8	216.9	393.7	225.3	232.2
% LFL Growth	19.1%	15.4%	17.1%	18.1%	15.0%
Oil, Gas & Chemical Services	302.0	333.3	635.3	374.3	359.4
% LFL Growth	8.9%	9.9%	9.4%	13.4%	15.0%
Life Sciences Services	62.0	63.3	125.3	94.0	101.2
% LFL Growth	18.2%	13.2%	15.5%	-1.8%	10.0%
Consumer Testing Services	214.2	262.0	476.2	283.4	260.3
% LFL Growth	26.0%	28.0%	27.2%	27.1%	20.0%
Systems & Services Certification	127.0	147.0	274.0	151.4	141.0
% LFL Growth	12.8%	17.1%	15.1%	15.7%	10.0%
Industrial Services	209.4	235.4	444.8	240.2	232.4
% LFL Growth	12.2%	12.8%	12.5%	11.5%	10.0%
Environmental Services	110.9	124.1	235.0	125.0	124.8
% LFL Growth	11.4%	6.8%	8.8%	6.9%	7.5%
Automotive Services	97.3	102.9	200.2	111.5	107.7
% LFL Growth	1.2%	-2.1%	-0.7%	3.3%	2.0%
Trade Assurance Services	119.5	109.1	228.6	83.3	107.6
% LFL Growth	-9.6%	-11.4%	-10.5%	-30.7%	-10.0%
<b>Total Revenue</b>	<b>1556.9</b>	<b>1751.0</b>	<b>3307.9</b>	<b>1845.1</b>	<b>1820.8</b>
Growth	12.0%	17.1%	14.7%	18.5%	16.9%
LFL Growth	11.3%	11.5%	11.4%	10.4%	10.5%

Operating Profit - by Division	H1 05	H2 05	FY 05	H1 06	H1 06 - Jef. Est.
	Agricultural Services	15.0	18.5	33.5	18.7
% Margin	10.9%	11.8%	11.4%	11.9%	12.0%
Minerals Services	27.2	35.9	63.1	37.6	39.5
% Margin	15.4%	16.6%	16.0%	16.7%	17.0%
Oil, Gas & Chemical Services	36.9	42.5	79.4	51.9	46.7
% Margin	12.2%	12.8%	12.5%	13.9%	13.0%
Life Sciences Services	8.7	10.4	19.1	11.4	16.2
% Margin	14.0%	16.4%	15.2%	12.1%	16.0%
Consumer Testing Services	45.6	56.5	102.1	64.6	59.9
% Margin	21.3%	21.6%	21.4%	22.8%	23.0%
Systems & Services Certification	19.7	26.8	46.5	27.7	25.4
% Margin	15.5%	18.2%	17.0%	18.3%	18.0%
Industrial Services	27.3	31.3	58.6	31.5	31.4
% Margin	13.0%	13.3%	13.2%	13.1%	13.5%
Environmental Services	11.0	15.0	26.0	11.3	13.7
% Margin	9.9%	12.1%	11.1%	9.0%	11.0%
Automotive Services	12.3	12.9	25.2	15.3	14.0
% Margin	12.6%	12.5%	12.6%	13.7%	13.0%
Trade Assurance Services	25.1	23.4	48.5	11.4	21.5
% Margin	21.0%	21.4%	21.2%	13.7%	20.0%
<b>Total Operating Profit</b>	<b>228.8</b>	<b>273.2</b>	<b>502.0</b>	<b>281.4</b>	<b>286.7</b>
% Margin	14.7%	15.6%	15.2%	15.3%	15.7%

Income Statement	FY 04	H1 05	H2 05	FY 05	H1 06	H2 06E	FY 06E	FY 07E	FY 08E
<b>Sales</b>	<b>2885</b>	<b>1557</b>	<b>1751</b>	<b>3308</b>	<b>1845</b>	<b>1983</b>	<b>3829</b>	<b>4295</b>	<b>4796</b>
<b>% change</b>	<b>17.6%</b>	<b>12.0%</b>	<b>17.1%</b>	<b>14.7%</b>	<b>18.5%</b>	<b>13.3%</b>	<b>15.8%</b>	<b>12.2%</b>	<b>11.6%</b>
Salaries and wages	1435			1615	1017	960	1977	2201	2438
Subcontractors' expenses	181			217		130	130	146	163
Others	761			834	467	489	956	1066	1194
<b>EBITDA</b>	<b>508</b>	<b>294</b>	<b>348</b>	<b>642</b>	<b>382</b>	<b>404</b>	<b>786</b>	<b>883</b>	<b>1000</b>
<b>EBITDA margin %</b>	<b>17.6%</b>	<b>18.9%</b>	<b>19.9%</b>	<b>19.4%</b>	<b>20.7%</b>	<b>20.3%</b>	<b>20.5%</b>	<b>20.5%</b>	<b>20.9%</b>
Depreciation and amortization	115	65	75	140	80	86	166	181	199
Recoveries on contracts	-3	0	0	0	0	0	0	0	0
Exceptionals					21		21	0	0
<b>EBIT</b>	<b>380</b>	<b>229</b>	<b>273</b>	<b>502</b>	<b>302</b>	<b>318</b>	<b>620</b>	<b>702</b>	<b>802</b>
<b>EBIT margin %</b>	<b>13.2%</b>	<b>14.7%</b>	<b>15.6%</b>	<b>15.2%</b>	<b>16.4%</b>	<b>16.0%</b>	<b>16.2%</b>	<b>16.3%</b>	<b>16.7%</b>
Financial result	6	4	1	5	-1	1	0	2	3
<b>Pre tax</b>	<b>386</b>	<b>233</b>	<b>274</b>	<b>507</b>	<b>301</b>	<b>319</b>	<b>620</b>	<b>704</b>	<b>805</b>
Taxes	93	55	64	119	73	77	150	169	193
Tax rate	24.1%	23.6%	23.4%	23.5%	24.3%	24.0%	24.1%	24.0%	24.0%
<b>Profit</b>	<b>293</b>	<b>178</b>	<b>210</b>	<b>388</b>	<b>228</b>	<b>242</b>	<b>471</b>	<b>535</b>	<b>612</b>
Minority	15	8	9	17	13	12	25	24	24
<b>Net income group share</b>	<b>278</b>	<b>170</b>	<b>201</b>	<b>371</b>	<b>215</b>	<b>230</b>	<b>446</b>	<b>511</b>	<b>588</b>
<b>Net income pre exceptionals</b>	<b>291</b>	<b>170</b>	<b>201</b>	<b>371</b>	<b>202</b>	<b>230</b>	<b>446</b>	<b>511</b>	<b>588</b>
Shares Outstanding	7.5	7.6	7.6	7.6	7.6	7.6	7.6	7.6	7.6
Earnings Per Share	37.12	22.38	26.47	48.85	28.45	30.42	58.86	67.46	77.59
Earnings Per Share - pre exceptionals	38.86	22.38	26.47	48.85	26.48	30.42	58.86	67.46	77.59

<b>Income Statement (CHFm)</b>	<b>2004</b>	<b>2005</b>	<b>2006E</b>	<b>2007E</b>	<b>2008E</b>
Year to December					
Turnover	2885.0	3308.0	3829.1	4295.2	4795.5
% change	17.6%	14.7%	15.8%	12.2%	11.6%
EBITDA	508.0	642.0	786.0	882.6	1000.4
margin %	17.6%	19.4%	20.5%	20.5%	20.9%
EBIT	380.0	502.0	620.4	701.9	801.8
margin %	13.2%	15.2%	16.2%	16.3%	16.7%
Pre-Tax	386.0	507.0	620.4	703.9	804.8
Net income	278.0	371.0	445.8	511.0	587.7
margin %	9.6%	11.2%	11.6%	11.9%	12.3%

<b>Balance Sheet (CHFm)</b>	<b>2004</b>	<b>2005</b>	<b>2006E</b>	<b>2007E</b>	<b>2008E</b>
Working Capital	139.0	223.0	357.0	460.1	561.7
WC as a % of turnover	4.8%	6.7%	9.3%	10.7%	11.7%
Capital Employed & goodwill	936.0	1238.0	1589.4	1841.4	2113.0
RoACE incl GW	44.9%	46.2%	43.9%	40.9%	40.6%
ROE	25.2%	27.0%	31.0%	28.2%	26.2%
Net Debt	-438.0	-430.0	-161.0	-310.2	-497.0
Gearing	-37.7%	-29.9%	-10.6%	-16.4%	-21.3%

<b>Cash Flow (CHFm)</b>	<b>2004</b>	<b>2005</b>	<b>2006E</b>	<b>2007E</b>	<b>2008E</b>
Cash Flow	486.0	598.0	626.0	715.7	810.2
Capex	-201.0	-205.0	-223.0	-214.8	-239.8
WCR	-61.0	-187.0	-178.0	-103.1	-101.5
Free-Cash Flow	224.0	206.0	225.0	397.8	468.9

<b>Key Valuation Ratios</b>	<b>2004</b>	<b>2005</b>	<b>2006E</b>	<b>2007E</b>	<b>2008E</b>
Shares Outstanding (m)	7.49	7.59	7.57	7.57	7.57
Stock Price (CHF)	721	956	1,088	1,088	1,088
Market Cap*	5395.8	7260.3	8240.5	8240.5	8240.5
EPS net	37.1	48.9	58.9	67.5	77.6
PER net	19.4	19.6	18.5	16.1	14.0
CFPS	64.90	78.74	82.65	94.49	106.97
PCF	11.1	12.1	13.2	11.5	10.2
P/NAV	4.6	5.0	5.4	4.3	3.5
ROE	25.2%	27.0%	31.0%	28.2%	26.2%
EV	4957.8	6830.3	8079.5	7930.3	7743.6
EV / Sales	171.8%	206.5%	211.0%	184.6%	161.5%
EBIT mg %	13.2%	15.2%	16.2%	16.3%	16.7%
EV / EBITDA	9.8	10.6	10.3	9.0	7.7
EV / EBIT	13.0	13.6	13.0	11.3	9.7
Yield %	1.3%	1.2%	4.7%	1.6%	1.9%

\* historical datas are average figures  
source: Jefferies International Ltd.

## 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 2005 revenues of CHF 3,308m, and employs over 40,000 people worldwide.

## ANALYST CERTIFICATIONS

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