SGS

NZB Neue Zürcher Bank

Company Review

Sector:
Switzerland - Services

Event:
Company Visit

Fair value NZB:
CHF 1,581

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Date:
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SGS 'testing' the bumps of the recession

Last week SGS reported its H1 2009 figures, which were below expectations. We had the chance to meet with the management to go through these figures and the business development in the different business units in detail.

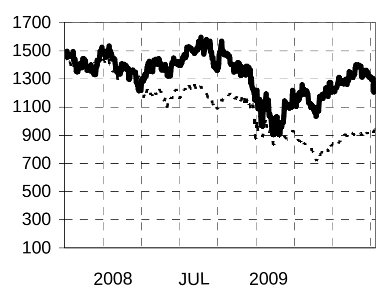
The organic growth rate slowed down significantly in the first half to 4.1% from 15.6% in H2 2008. Although nine of the group's ten divisions were able to report some growth, the Minerals division was hit hard by the economic downturn. In spite of the slowdown, SGS was able to improve its operating margin by 10bp, mainly thanks to an outstanding profitability boost in the Consumer Testing division. That result was good enough for the management to confirm its outlook issued at the beginning of the year calling for single-digit growth and a stable margin. SGS made only one tiny acquisition in the first half. According to the management, the M&A environment remains dire, but we should expect some more activity in the second half of the year.

Based on the results and the management's comments, we have adjusted our estimates – which were already conservative prior to the results release – for the different divisions to reflect their different dynamics. As a result, we have reduced our EPS forecasts mainly due to our updated assumptions about the currency impact. Based on our new estimates, we derive a new 'fair value NZB' of CHF 1,581 per share (vs. CHF 1,606 previously).

The management is doing its best to face the headwinds, but we believe that it will be very challenging to reach the margin target, as SGS recorded its best profitability ever in H2 last year with an EBIT margin of 17.5%. Furthermore, as confirmed by the management, there is currently no 'hot' target in the pipeline that could act as a trigger for the stock. Although we remain bullish on the industry's structural growth prospects and on SGS specifically, we believe that the aforementioned headwinds will preponderate in the near term. We are therefore maintaining our NEUTRAL rating on the stock.

Market cap.	**CHF m**	**9252**
Last price	CHF	1238
52 week high	CHF	1563
52 week low	CHF	872
YTD performance	%	12.5
Economic value	**CHF**	**1581**
Soft factor ded.	%	0.0
Fair value NZB	**CHF**	**1581**
Div. ranking shs	m	7.5
Symbols		SGSN.VX, SGSN VX

SGS and SPI relative



Key figures (CHF)	**2007**	**2008**	**2009E**	**2010E**	**2011E**	**CAGR 06-11E**
Net revenues (m)	4372	4818	4850	5062	5346	6.9
Growth rate (%)	14.4	10.2	0.7	4.4	5.6	
EBITDA (m)	908	1'024	1'026	1'070	1'148	8.1
Margin (%)	20.8	21.3	21.2	21.1	21.5	
EBIT (m)	711	810	792	815	872	7.6
Margin (%)	16.3	16.8	16.3	16.1	16.3	
Net profit (m)	500	692	549	576	615	6.8
Dividend	35.0	50.0	34.0	38.0	42.0	16.0

EPS revision	**2007**	**2008**	**2009E**	**2010E**	**2011E**	**CAGR**
EPS new	65.5	92.6	73.5	77.1	82.3	7.2
EPS old			77.7	79.5	85.3	
% change			-5.4	-3.0	-3.5	

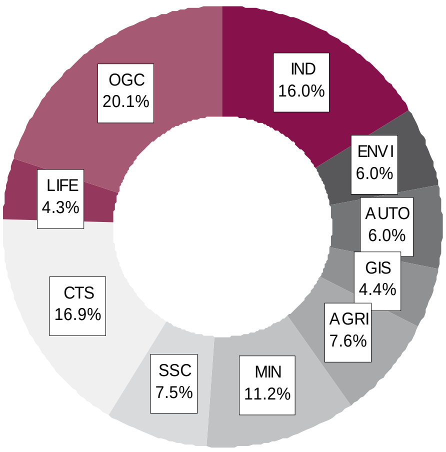
Valuation (x)	**2007**	**2008**	**2009E**	**2010E**	**2011E**
P / E	22.3	13.4	16.8	16.1	15.1
P / CEPS	21.0	12.8	15.8	15.1	14.1
P / BV	5.7	5.1	4.5	3.9	3.4
EV / EBITDA	10.9	7.8	8.6	8.0	7.3
Dividend yield (%)	2.4	4.0	2.8	3.1	3.4

H1 2009 results in a nutshell

After the record year in 2008 with a buoyant second half, the bar was set high for SGS for 2009. Last March, the group issued a rather bullish update after the first two months of 2009, so expectations were high for the first half. Hence, the reported H1 4.1% organic growth rate received a mild welcome by the market. This is a sharp slowdown compared to the second half of 2008, which saw an organic growth rate of 15.6%. This internal growth was offset by a negative currency impact of 4.7% (mostly translational). Acquisitions net of disposals had a positive impact of 1.9%, causing sales revenue to increase by 1.3% to CHF 2.327bn in H1 2009.

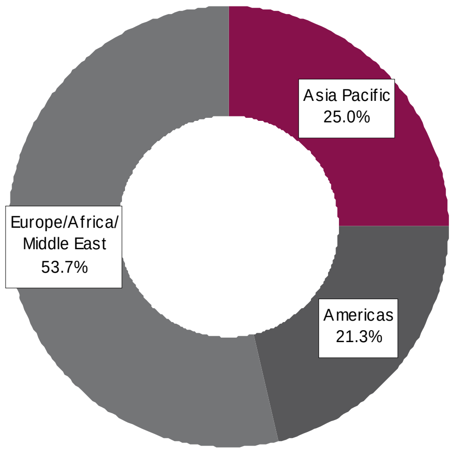
Four divisions – Consumer Testing (CTS), Agricultural, Industrial and Government & Institutions (GIS) – posted an excellent start to the year with an organic growth rate exceeding 10%. In contrast, Minerals was hit hard by a sharp slowdown that began last October due to heavy cuts in exploration projects, among other things. That division posted a revenue contraction of 9.1% and was the only SGS division that reported negative growth.

Fig. 1: Divisional sales split H1 2009



Source: Company data, NZB Neue Zürcher Bank

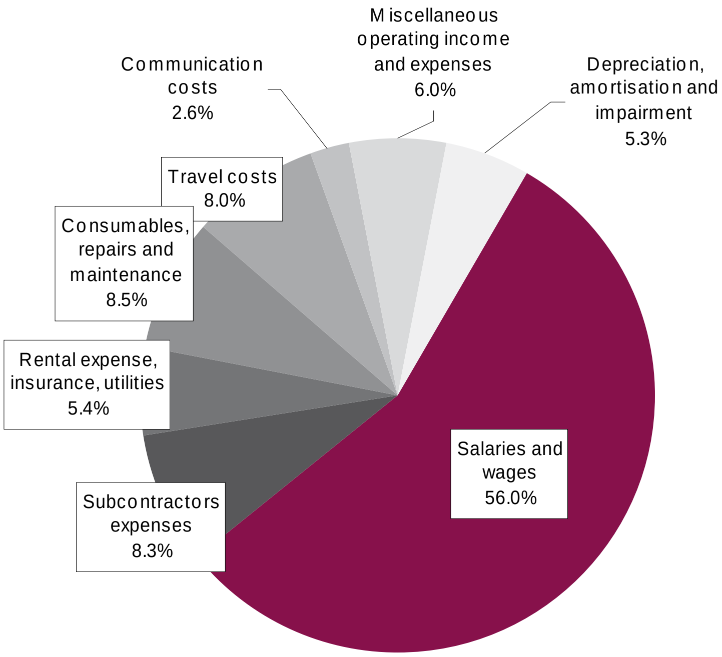
Fig. 2: Geographical sales split H1 2009



Source: Company data, NZB Neue Zürcher Bank

Thanks to the organic growth rate, efficiency gains, volume leverage, the service mix and the favorable geographical distribution of revenue, SGS was able to slightly increase its operating margin before exceptional items by 10bp to 16.2%. Overall operating costs edged up by 0.1% (vs. sales up 1.3%). Personnel and subcontracted costs increased 2.9% to CHF 1.279bn, or to 55.0% of sales, a 90bp increase compared to last year. The group headcount increased by 2.9% to 56,674 as of end-June 2009, up 1,534. Nearly 90% of the increase came from the Asia-Pacific region. In contrast, other operating expenses (excluding depreciation, amortization and impairment charges) decreased by 3.4%. As a percentage of sales, that represents a 110bp improvement to 24.2%. Although SGS does not break out those costs in the half-year results, we believe that the decrease was mainly due to a reduction in travel expenses.

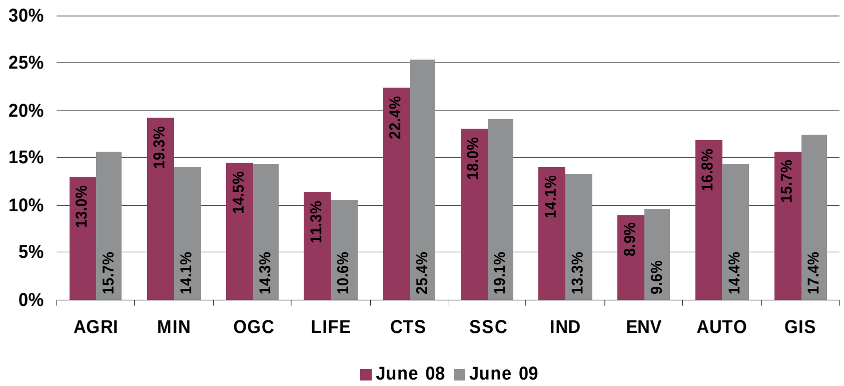
Fig. 3: Breakdown of costs in 2008



Source: Company data, NZB Neue Zürcher Bank estimates

This satisfying result was mainly achieved thanks to significant margin improvements in the Agricultural, CTS, Systems & Services Certification (SSC) and GIS divisions, which were able to offset the dramatic margin drop in the Minerals division (down 520bp to 14.1% due to the revenue plunge in high-margin exploration activities) and to a lesser extent in the Automotive division (down 240bp to 14.4%). The Life Science (LS) division was once again unable to stop disappointing, reporting a 70bp margin drop to 10.6% (we were expecting an improvement to 13%). Worthy of special mention were the great results in the Agricultural division (margin improvement of 270bp to 15.7%) and the CTS division (margin improvement of 300bp to 25.4% thanks to favorable business mix – overproportionate growth in chemicals testing).

Fig. 4: Operating margin development by division



Source: Company data, NZB Neue Zürcher Bank estimates

SGS recorded an exceptional charge of CHF 15m (CHF 9m after tax) in H1, with more than three-quarters of that related to workforce reductions (mainly in the Minerals division, by more than 1,000). The bulk of the CHF 15m charge was allocated to the following divisions: Minerals (CHF 5.5m), Industrials (CHF 2.3m), Oil, Gas & Chemicals (OGC; CHF 2.1m) and Automotive and Agricultural (CHF 1.4m), with the rest spread among the other divisions. This contrasts with the CHF 127m exceptional gain reported last year, consisting of a CHF 147m gain on the settlement of an outstanding receivables issue with the government of the Philippines less CHF 20m in legal and financial fees. Including the exceptional items, net profit for the first half of 2009 dropped 32.5% year-on-year to CHF 244m. However, excluding the one-offs, SGS was able to report a flat net profit of CHF 264m (CHF 265m).

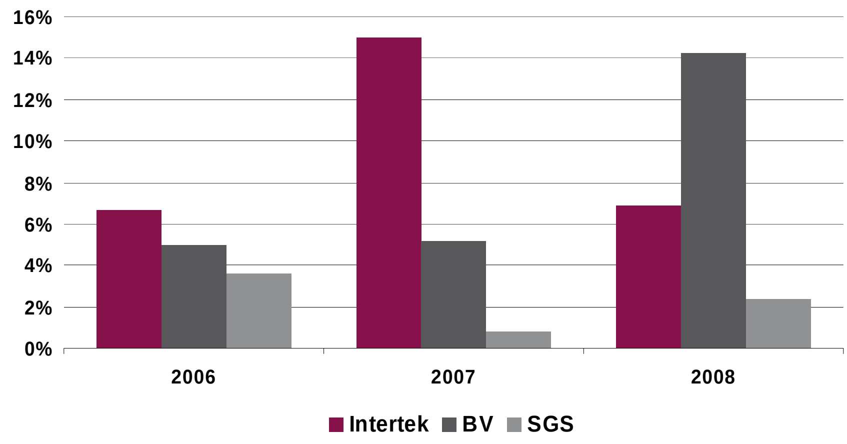
Operating cash flow before exceptional items decreased by 5.6% to CHF 286m, mainly as a result of a timing difference in cash tax payments from the group's Swiss entities. The management expects the difference to unwind in the second half of the year. The net working capital trend was relatively stable with a increase of CHF 53m (CHF 96m in the previous year), which is a robust result considering the environment. This was mainly made possible by the CFO's ongoing focus on and review of the quality of SGS's receivables. Last autumn, the credit crunch prompted the management to further heighten its awareness, and already in the second half of 2008 SGS proactively stopped providing its services to several Chinese companies (mainly toy manufacturers). As a result, the bad-debts situation in the first half of 2009 was better than in the past year, which is quite a stunning result in the current environment. DSO (days sales outstanding) marginally increased by 1.5 days (to slightly more than 60 days).

Acquisitions in slow gear

SGS made only one tiny acquisition in the first half of 2009, taking over Ustav Paliv, the market leader in the Czech Republic for fuel testing. That company has annual sales of around CHF 4m, and the total cash outflow for this acquisition amounted to CHF 3m.

This relative tame activity when compared with last year (twelve acquisitions) does not pertain just to SGS, but to the entire sector including the two other publicly traded players Bureau Veritas and Intertek, which were even more active than SGS on the acquisitions front in the past years (see chart below). Although acquisition activity should pick up somewhat in the second half, the management hinted that the pipeline is not as full as in previous years and that the overall environment remains pretty dire. SGS is generally targeting small players that are local champions in their respective technologies. These companies usually generate high returns, and it looks like they are not willing to sell in a depressed environment. For others like in the minerals industry, for instance, some players are still expecting to be able to sell on the peak results reached in 2008. In any event, SGS will remain very disciplined, and the management made it clear that it would rather give cash back to shareholders (board decision in 2010) than spend it on overpriced acquisitions.

Fig. 5: Acquisitions impact on sales for the industry's key players 2006–2008



Source: Company data, NZB Neue Zürcher Bank

We, however, believe that SGS should be able to continue in the future to add two to three percentage points of growth per year through acquisitions. However, no major deal is imminent, in our view. Larger-scale acquisitions in the existing businesses – such as of mineral or oil services companies – that were targeted in the past years are no longer on the top of the priority list.

- **CHF 250m share buyback program**

On 21 November, SGS announced that it had completed its share buyback program that it started on 22 March 2007. A total of 209,628 shares (2.68% of the share capital) were repurchased during that period, in line with the approved CHF 250m program. Two months later, together with the FY 2008 results released, SGS announced that the board had authorized another share buyback program of up to CHF 250m. In the first half of 2009, no shares were repurchased. The management stated that it could take 'pieces or all' of the program in the second half of the year, depending on business and the share-price development. As a reminder, two-thirds of the total repurchases of the previous program occurred during the last two months of the program initiated three years earlier. Based on the annual report, SGS owns around 350,000 treasury shares, or 4.5% of the group's share capital (shares are not for cancellation).

- **Outlook confirmed**

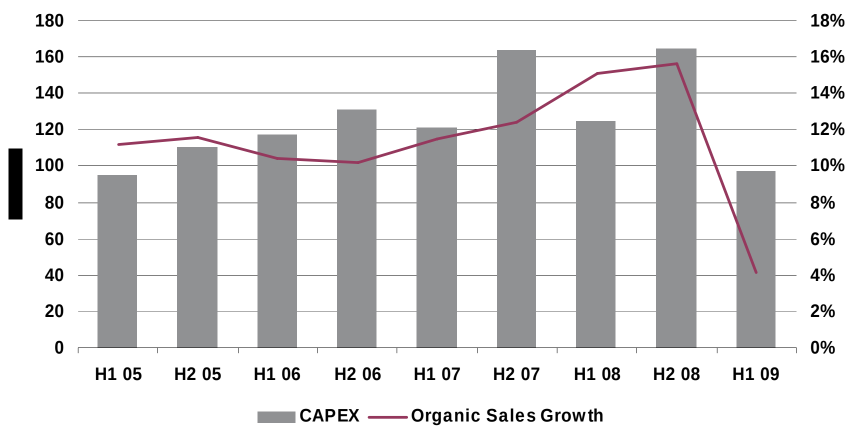
As expected, SGS confirmed its outlook communicated last January. The management believes that the target of reaching a single-digit organic growth rate and maintaining the operating margin at last year's level is realistic.

With regard to restructuring costs, the management said initially that the CHF 15m booked in H1 should probably be sufficient. Interestingly, though, it added that in the second half of the year, restructuring costs could range from CHF 0m to CHF 50m, depending on the business development. However, a more realistic forecast has now been issued, projecting around CHF 20m of restructuring charges for 2009.

Furthermore, the group has slashed its investments this year, reflecting the dramatic drop in top-line growth. In the first half, capex was down 22%. Investments in the Minerals division were reduced by 70%. The management expects capex for the full year to amount to a maximum of CHF 200m, corresponding to a reduction of more than 30%. In other words, the management is planning to cut investments further in the second half of the year, mainly in the Minerals, OGC and Industrial divisions in our view.

Typically, SGS needs around CHF 100m to run the business (maintenance capex), with the rest being dedicated to strategic growth initiatives and to more tactical investments for short-term opportunities. We believe that the management is refraining from investing in the latter area for the time being, focusing on the more strategic long-term projects. The management stated that it is closely monitoring the business development in the different divisions and is constantly updating its investment plan. If revenue growth edges upward again in the coming months, the management would then revise its plan upward. That high flexibility should enable SGS to increase its cash per share this year.

Fig. 6: Half-year development of CAPEX vs. organic sales growth 2005–2009



Source: Company data, NZB Neue Zürcher Bank

Finally, the EPS target of CHF 105 per share by 2011 remains valid. As a reminder, this target includes possible future acquisitions.

■ Reduction of NZB estimates

We had relatively conservative assumptions prior to the results release. We have left our assumptions broadly unchanged, but with some adjustments to reflect the different dynamics in the various divisions.

We have slightly reduced our top-line growth estimate in view of the actual currency impact in H1 and our updated assumptions for H2. Our top-line growth estimate for 2009 now reads as follows: organic growth rate of 3.7% (vs. 4.9% previous estimate), negative currency impact of –4.2% (vs. –1.5%), positive impact from acquisitions net of disposals of 1.2% (vs. 0.9%). Our margin assumption remains unchanged at 16.3%, below the group's guidance (16.8%). Furthermore, based on the management's comments, we have cut our capex forecasts accordingly.

Our estimate changes reduce our EPS estimates by 5.4% for 2009, 3.0% for 2010 and 3.5% for 2011.

■ Valuation

On our adjusted estimates (excluding future acquisitions), we now derive a new 'fair value NZB' – based on EVA®/DCF models – of CHF 1,581 per share (vs. CHF 1,606 previously).

Based on our new estimates, SGS is trading at a P/E 2009E of 16.8x and an EV/EBITDA 2009E of 8.6x. This valuation stands at a premium to competitors Intertek and Bureau Veritas. We consider a premium of at least 10% versus both competitors justifiable given SGS's superior business mix (lower risk profile) and its sound financial situation.

Conclusion and recommendation

The management is doing its best to face the headwinds, but we believe that it will be very challenging to reach the margin target, as SGS recorded its best profitability ever in H2 last year with an EBIT margin of 17.5%. However, we believe that the management is running the business by focusing on absolute profitable growth and capital returns, which we totally agree with. Flexing capex in line with top-line growth should therefore enable the group to increase its cash per share this year. We believe that reaching that metric is much more shareholder-friendly than wanting to attain the 16.8% margin target at any price. On the M&A side, there is currently no 'hot' target in the pipeline that could act as a trigger for the stock. Although we remain bullish on the structural growth prospects and on SGS specifically, we believe that the current headwinds in the Minerals and Chemicals industries leave some uncertainties about the development in the second half. We are therefore maintaining our NEUTRAL rating on the stock.

Agenda

- FY 2009 results — 15 January 2010

Fig. 7: H1 performance of the different business units and their outlook

Business units	H1 2009 performance	Outlook FY 2009
Agricultural	Excellent half with double-digit growth and record margin. Benefiting from the global players getting bigger (Cargill, Bungee).	Slowdown, tougher market conditions in grains expected, tightening of export market in the Black Sea and EU regions.
Minerals	Organic sales decrease, significant margin drop due to the collapse of high-margin exploration activities (20% of sales). Trading activities with good growth. Restructuring, headcount reduction (more than 1,000).	Tough market conditions expected to continue because mining and metals companies are holding off on investments.
OGC	Chemicals (20% of division's sales) depressed, but Oil & Gas doing relatively well (upstream service); market-share gain in cargo treatment across Asia-Pacific region.	Ongoing weakness in the chemicals market, ongoing positive development in the upstream part of the business, margin improvement from investments in global network.
Life Science	Tough start in clinical research, QC activities relatively robust. Asian lab with increasing leverage and improving profitability. Overall, a rather disappointing result.	Positive outlook for the Asian activities (huge potential in QC in India, Singapore, Thailand), clinical research should expect good business as well in H2. Single-digit growth with improved margins expected.
CTS	Stunning half-year with double-digit growth, largely driven by US legislation (CPSIA) for toys and softlines, and record margin, thanks to favorable business mix (chemical testing).	Strength and timing of retail demand (Xmas business) remains uncertain, overall cautiously optimistic outlook. Growth rates expected to slow down in H2.
SSC	Good growth in a declining market thanks to market-share gains, and record margin thanks to productivity projects and positive geographical mix.	Price pressure expected, but ongoing efficiency gains. Introduction of new services, focus on global clients.
Industrial	Mid-single-digit growth thanks to strong performance in Germany (liberalization of the German market in 2008). Significant decrease in business in Spain (the division's biggest market). Slight margin decrease due to the consolidation of PiD, a Brazilian company acquired last year.	Cautious outlook, large capex projects still on hold, effects to be seen not before 2010. Interest/focus on renewable energy and asset management integrity services.
Environmental	Slow half-year with tough conditions in Spain, France, the USA and Australia. Margin expansion thanks to better mix and cost control. New contracts secured with multinational companies.	No big improvement expected, with cost control to remain a focus in order to protect the profit margin.
Automotive	Statutory vehicle inspection (70% of sales) with good performance, difficult market conditions in the commercial inspection business. Flat sales with decreasing margins (2008 with driving license tests in Ireland with high profitability).	Unchanged picture in the second half. Greenfield and privatization opportunities in the statutory field. Off-lease product to improve gradually.
GIS	Double-digit growth thanks to new contract wins, market-share gains and scanners business. Margin improvement thanks to the scanners (installed last year).	Stable PSI activities expected, deployment of TradeNet and scanning solutions remain the focus in H2.

Source: Company data, NZB Neue Zürcher Bank

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