

**Rating** **Neutral 1**  
*Prior: Buy 1*
**Price target** CHF875.00/US\$7.47  
*Prior: CHF860.00/US\$7.34*
**Price** CHF813.50/US\$6.89 (ADR)

RIC: SGSN.VX BBG: SGSN VX

17 January 2005

**Trading data (local/US\$)**

52-wk. range	CHF831.50-642.00/US\$7.18-5.06
Market cap.	CHF6.36bn/US\$5.39bn
Shares o/s	7.8m (REG)/782m (ADR)
ADR ratio	100 ADR :1 REG
Free float	62%
Avg. daily volume ('000)	28/OTC
Avg. daily value (CHFm)	21.5

**Balance sheet data 12/04E**

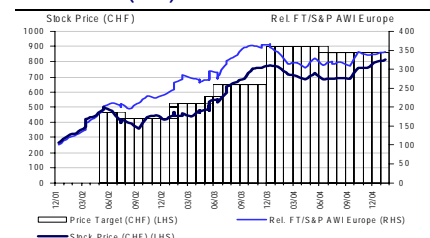
Shareholders' equity	CHF1.24bn
P/BV (UBS)	5.1x
Net cash (debt)	CHF0.44bn

**Forecast returns**

Forecast price appreciation	+7.6%
Forecast dividend yield	1.5%
Forecast stock return	+9.1%
Market return assumption	5.8%
Forecast excess return	+3.3%

**EPS (UBS, CHF)**

	12/04E			12/03
	From	To	Cons.	Actual
H1E	16.89	16.80	-	13.41
H2E	20.64	20.53	-	16.50
12/04E	37.53	37.33	37.62	
12/05E	47.33	45.29	44.87	

**Performance (CHF)**


Source: UBS

[www.ubs.com/investmentresearch](http://www.ubs.com/investmentresearch)
**UBS Investment Research**
**SGS**

## Outlook still promising but upside potential limited

### ■ Impressive 2004 results

SGS reported strong 2004 results which were broadly in-line with our estimates and at the lower end of consensus. The highlights of the results were: (1) robust organic sales growth (reaching +11.3% y/y in H2 04); (2) margin progression to 14.0% in H2 04 (but still short of 16%) and (3) strong cash flow generation (FCF of CHF226m and CHF438m net cash).

### ■ Time to look beyond 2005

In our view, the focus on the 2005 financial targets is fading, with SGS expected to reach its CHF45 EPS target, while the 16% margin target looks likely to be achieved only by FY 06. We expect the focus to shift towards SGS's growth prospects beyond 2005 and its ability to reach, and more importantly sustain margins of roughly 16%.

### ■ New CEO; M&A activity

Sentiment in the near-term is likely to depend on the perception of the new CEO (announcement expected within the next few weeks) as well as the level of M&A activity (which should have a material impact on estimates).

### ■ Valuation: Neutral 1 (from Buy 1); CHF875 PT (old CHF860)

Following revisions to our estimates, our DCF valuation now implies a PT of CHF875 (old CHF860). While the outlook for SGS remains promising, in our view, we see limited upside potential given the recent share outperformance and we therefore cut our rating to Neutral 1 from Buy 1.

Highlights (CHFm)	12/02	12/03	12/04E	12/05E	12/06E
Revenues	2,392	2,454	2,885	3,130	3,410
EBIT	207	290	375	480	548
Net income (UBS)	169	234	292	354	404
EPS (UBS, CHF)	21.56	29.91	37.33	45.29	51.62
Net DPS (UBS, CHF)	7.25	9.00	12.00	15.00	17.00

Profitability & Valuation	5-yr hist. av.	12/03	12/04E	12/05E	12/06E
EBIT margin %	6.3	11.8	13.0	15.3	16.1
ROIC (EBIT) %	21.2	39.9	42.6	45.3	48.4
EV/EBITDA x	13.6	10.8	12.2	10.2	8.8
PE (UBS) x	26.9	19.5	21.8	18.0	15.8
Net dividend yield %	1.5	1.5	1.5	1.8	2.1

Source: Company accounts, Thomson Financial, UBS estimates. UBS EPS is stated before goodwill, exceptionals and other special items. Valuations: based on an average share price that year, (E): based on a share price of CHF813.50 on 16 Jan 2005

Darren Cohen

 darren.cohen@ubs.com  
 +41 1 239 1657

Mark Shepperd

 mark.shepperd@ubs.com  
 +44-20-7568 1977

Grant Chum

 grant.chum@ubs.com  
 +44-20-7568 8125

**ANALYST CERTIFICATION AND REQUIRED DISCLOSURES BEGIN ON PAGE 10**

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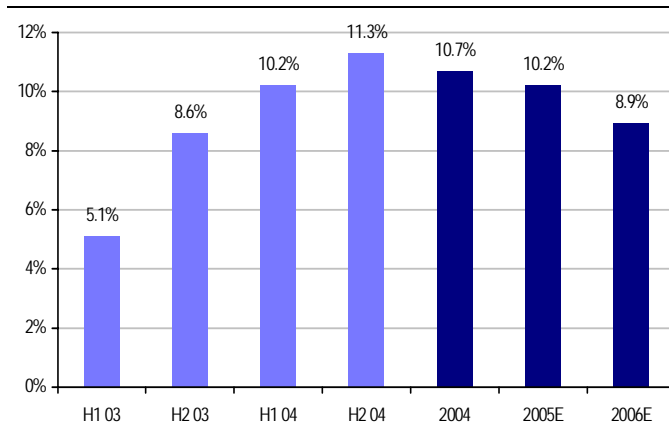
## Results overview

SGS reported its FY 04 results on 14 January, which were broadly in-line with our estimates and at the bottom end of consensus. FY 04 sales came in at CHF 2.89bn (+18% y/y; +10.7% organic growth; UBSe CHF2.84bn; consensus CHF2.84-2.87bn). FY 04 EBITA stood at CHF391m (13.6% margin for the FY 04 and a 14.0% margin in H2 04; UBSe CHF387m; consensus CHF385-397m). FY 04 reported net income was CHF279m (+23% y/y; UBSe CHF277m; consensus CHF275-300m). SGS also generated CHF226m free cash flow and reported a net cash position of CHF438m for FY 04. Overall, an encouraging set of results, with no changes by management to the existing FY 05 targets.

## Impressive organic sales growth to continue

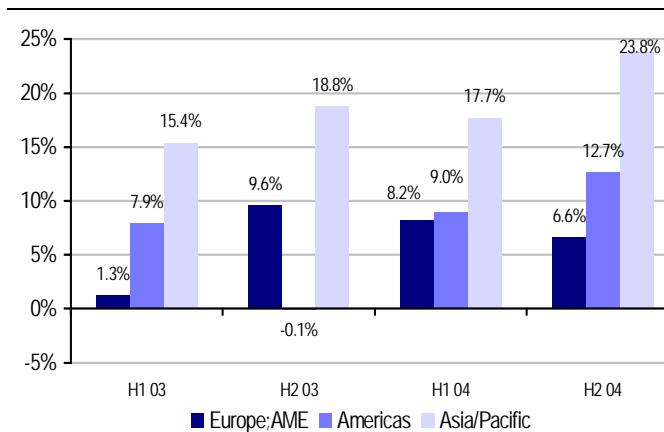
Organic sales growth accelerated from +6.5% in 2002 to +7.0% in 2003, and reaching 10.7% in 2004. While the growth rate in H1 04 of +10.2% was regarded as almost exceptional, the growth in fact accelerated further, reaching +11.3% in H2 04. It is worth noting that those divisions that reported double-digit growth in 2004 accounted for 66% of total sales. Although the commodity-related businesses (Minerals and OGC) have certainly benefited from a favourable environment during 2004 and have contributed to the strong performance, four other divisions achieved organic growth rates in excess of c+9% y/y during 2004 (CTS, Industrial, Environmental and TAS). While Asia-Pacific continues to be the main driver of growth, it appears that both Europe/AME and Americas are now also contributing to the growth.

Chart 1: SGS's organic sales growth rates



Source: SGS; UBS estimates

Chart 2: Organic sales growth by geographic region

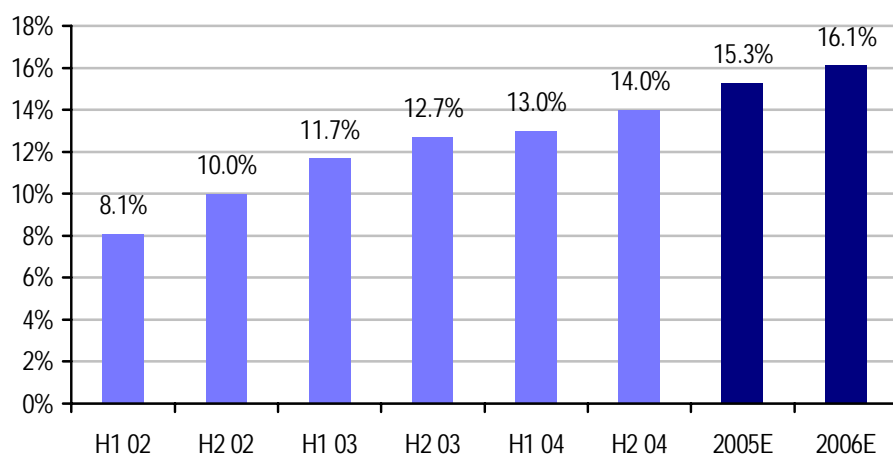


Source: SGS

During the FY 04 analyst conference, management gave fairly promising outlook statements for each of the 10 divisions, with no specific concerns raised for even one division for 2005. We expect the overall growth momentum to continue into 2005, declining only marginally to +10.2% y/y from +10.7% in FY 04 (please refer to our divisional estimates below for specific details regarding our divisional sales forecasts). Since SGS has been investing heavily on capex over the past 2 years and has indicated that the level of capex is unlikely to decline substantially in the near-term, this should also support the above average organic sales growth.

## “We will continue to drive towards 16%”

Chart 3: EBITA margin forecasts



Source: SGS; UBS estimates

**16% target to be reached in 2006 not 2005?** – We believe the answer to this question is evident in SGS’s CFO Richard Tobin’s response to a specific question about the 16% margin target for 2005 where he replied “We will continue to strive towards the 16.0%”, without qualifying the existing target. The fact that SGS’s emphasis on the 2005 targets has shifted almost entirely towards the CHF45 EPS also supports this view. Management were unable to offer improved visibility in terms of quantifying the factors leading to the margin expansion to the 16% target. We had previously assumed in our estimates that SGS would in fact reach the 16% margin target by 2005. While the margin progression to date has been impressive, it now seems unlikely that it will bridge the gap to 16% by the end of 2005 but rather by 2006, with certain divisions expected to overshoot the original divisional margin targets, while others may fall short of the targets. We suspect that the rationale for the constant reiteration of the 16% target, despite it becoming increasingly unlikely that it is reached by 2005, is to sustain the internal pressure within the company, rather than for external purposes. Since the 16% EBITA margin is not required in order for the company to reach its CHF45 EPS target in our view, and the fact that the consensus margin estimate for 2005 stands below 16%, missing the margin target for 2005 should not provide a disappointment in the market. We believe sentiment is likely to remain positive regarding margin expansion as long as SGS is able to demonstrate its ability to constantly raise the margin towards 16%. We have assumed in our estimates that SGS should be able to lift its margin to 15.3% in 2005E (previously 16.0%) and to 16.1% in 2006E (previously 16.4%). There still appears to be margin upside potential across all 10 divisions (see divisional EBITA forecast breakdown below). With margins now at a fairly high level (14.0% in H2 04), we expect bolt-on acquisitions to provide only limited support in the margin progression. We expect the margin expansion to be driven by several factors including but not limited to: operational leverage; favourable margin mix with a shift towards higher margin services; six-sigma; favourable geographic mix; and price increases.

## M&A Activity

**Large scale acquisitions** - As discussed in our previous notes, we think the most likely acquisition/merger scenario between any of the main 3 players – SGS, Bureau Veritas (BV) and Intertek – would be an SGS/BV deal (please refer to our note – “*Momentum to continue*” - December 3, 2003 for further analysis). SGS’s interim CEO, Johan Allegaert, indicated that SGS is currently not in discussions with BV. Although speculation of a potential deal seems to surface from time to time, especially now that Wendel Investments has raised its stake in BV to 99% (Wendel acquired the shareholding of the founding families - Poincarè Investments as well as the minority shareholders), we believe that the probability of a deal materializing in the near-term is quite low. First, since the organic growth opportunities for SGS are likely to remain attractive in the medium term, we believe SGS’s appetite for a large-scale acquisition at this stage is rather small. Considering that both SGS and Intertek are trading on 2005E EV/Sales multiples of 2.0x, assuming a similar multiple for BV would result in a value for BV of roughly CHF4.3bn, which amounts to roughly 67% of SGS’s current market capitalisation. Given the strong financial and share performances of SGS and Intertek (since its IPO in 2002), we believe that a BV initial public offering could be more financially attractive in the short-term for Wendel Investments versus a potential deal with SGS. Having said this, any decision on a potential deal would basically rest with Wendel Investments and the main 2 shareholders of SGS (Worms and Von Finck).

**Bolt-on acquisitions** - In 2004, bolt-on acquisitions contributed c9% towards 2004 sales and c8% towards EBITA (representing a margin of c14.7%). While the acquisitions only had a slight impact on margins for 2004, we estimate that excluding integration costs, the acquisitions added roughly 6% to group EPS for 2004. We estimate that the average price paid for bolt-on acquisitions during 2004 was between 1.0 to 1.3x price/sales. Since SGS has indicated that it could spend the remainder of its net cash position on bolt-on acquisitions, we estimate that assuming price/sales multiples of 1-1.5x price/sales and an EBITA margin of 15%, SGS could lift its 05/06E EPS by 7-13%. Our assumptions below exclude any potential integration costs, as well as any potential synergies from these acquisitions.

**Table 1: EPS enhancements from potential bolt-on acquisitions**

CHFm	Price/Sales of 1.0x	Price/Sales of 1.5x
Net cash position at Dec 2004	438	438
Acquired Sales	438	292
Acquired EBITA (assuming a margin of 15%)	66	44
Less: Interest earned on net cash @ 1.5%	- 7	- 7
<b>Total PBT enhancement</b>	<b>59</b>	<b>37</b>
Less: Tax @ 23.5%	- 14	- 9
<b>Net profit from acquisitions</b>	<b>45</b>	<b>28</b>
<b>Incremental EPS (@7.82m shares)</b>	<b>5.8</b>	<b>3.6</b>
<b>% of 05E EPS</b>	<b>13%</b>	<b>8%</b>
<b>% of 06E EPS</b>	<b>11%</b>	<b>7%</b>

Source: UBS estimates

## Pending CEO announcement

**New CEO within the next few weeks** - Management have indicated that they have identified a CEO candidate and expect to make an announcement within the next few weeks. Assuming the new CEO is not from within the SGS group, we expect sentiment in the stock to remain fairly subdued until the new CEO is ready to announce any changes in the group's strategy or new financial targets (which potentially could take several months as he becomes familiar with the group). A well-received CEO is likely to be quite positive for sentiment given the extent of management changes during 2004. We think it is unlikely that the group's strategy/structure will change significantly under a new CEO, but we would expect M&A activity to increase.

**New financial targets?** - With SGS continuing to make progress in reaching its 2005 targets, in order to sustain the pressure internally and externally (competitors), we think it is likely that new challenging financial targets will be set by the new CEO. With SGS having come under some criticism for setting absolute financial targets for 2005 (as the EPS and margin target can to an extent be influenced by certain factors, e.g. bolt-on acquisitions), we believe SGS is likely to set targets similar in nature to the targets set recently by Bureau Veritas. Bureau Veritas announced a 5-year growth plan, aiming to double revenues by 2009 through organic growth of >6% p.a. as well as external growth, and is targeting a sustainable EBITA margin of >15%. We expect sentiment to be driven by the nature and extent of the targets set.

## Changes to our estimates

Table 2: Summary of changes to estimates

CHFm	New Estimates			Old Estimates			% change to estimates		
	2004 (Actual)	2005E	2006E	2004E	2005E	2006E	2004	2005E	2006E
Revenues	2,885	3,130	3,410	2,839	3,113	3,357	2%	1%	2%
% change	17.6%	8.5%	8.0%	15.7%	9.7%	7.9%			
EBITA	391	480	548	387	497	552	1%	-3%	-1%
% EBITA margin	13.6%	15.3%	16.1%	13.6%	16.0%	16.4%			
Reported net profit	279	354	404	277	370	411	1%	-4%	-2%
% change	23%	27%	14%	22%	34%	11%			
Stated EPS (@7.82m shares)	35.7	45.3	51.6	35.4	47.3	52.5			

Source: UBS estimates; SGS

We have made slight changes to our sales estimates for 2005/06 resulting in a 1-2% change. As mentioned above, we have also lowered our margin assumptions for 2005 to 15.3% and to 16.1% for 2006 with the revision stemming from several divisions (see below). The net changes to our 05/06 EPS estimates are between 2-4%.

Table 3: Divisional sales forecasts

CHFm	2003	H1 04	H2 04	2004	2005E	2006E	Comment
<b>Agricultural Services</b>	<b>242</b>	<b>124</b>	<b>133</b>	<b>257</b>	<b>269</b>	<b>288</b>	- The division seems to have recovered in H2 04, however, we forecast only moderate growth into 2005/6 (UBSe +7% y/y) as we believe the shift towards the higher growth upstream services is likely to take some time, while the traditional inspection business should continue to be volatile (influenced by global weather conditions)
% change vs. py	-3.4%	1.9%	10.9%	6.3%	4.6%	7.0%	
Organic	0.0%	1.0%	14.4%	7.4%	7.0%	7.0%	
Currency	-3.4%	-0.9%	-3.5%	-1.0%	-2.4%	0.0%	
<b>Minerals Services</b>	<b>280</b>	<b>151</b>	<b>169</b>	<b>320</b>	<b>345</b>	<b>372</b>	- Besides Consumer Testing, the Minerals Services division reported the highest organic growth in H2 04 (+21% y/y) supported by high commodity prices and demand. We expect the momentum to continue into 2005 however, at a lower pace
% change vs. py	4.3%	13.7%	14.5%	14.1%	7.8%	8.0%	
Organic	4.8%	12.2%	20.6%	16.0%	11.0%	8.0%	
Currency	-5.6%	1.6%	-6.1%	-1.9%	-3.2%	0.0%	
<b>Oil, Gas &amp; Chemicals</b>	<b>439</b>	<b>283</b>	<b>292</b>	<b>575</b>	<b>614</b>	<b>663</b>	- Double-digit org growth in Asia: Central & East. Europe & Americas. OGC is seeing significant growth in the traditional inspection business (UBSe c30% of total) supported by several new outsourcing contract wins - Acquisitions are now fully integrated and should support sales growth - Management expect to sustain double-digit growth in 2005 (UBSe 10% vs. previous estimate of +8% y/y)
% change vs. py	10.1%	33.3%	28.6%	30.9%	6.8%	8.0%	
Organic	15.7%	12.6%	13.1%	12.6%	10.0%	8.0%	
Currency	-6.3%	0.0%	-5.0%	-1.9%	-3.2%	0.0%	
M&A (absolute)	3	44	45	89	0	0	
<b>Life Sciences Services</b>	<b>59</b>	<b>51</b>	<b>56</b>	<b>107</b>	<b>118</b>	<b>124</b>	- Since acquisition activity for this division will likely continue, we believe that the organic growth rate will only start to accelerate once acquisitions have been absorbed and critical mass has been reached
% change vs. py	-4.1%	72.0%	88.5%	80.2%	10.8%	5.0%	
Organic	-4.5%	-4.7%	-3.8%	-4.2%	5.0%	5.0%	
Currency	0.5%	2.4%	-8.4%	0.0%	-1.7%	0.0%	
M&A (absolute)	0	22	28	50	8	0	
<b>Consumer Testing</b>	<b>272</b>	<b>166</b>	<b>195</b>	<b>361</b>	<b>417</b>	<b>475</b>	- The aggressive marketing efforts made in 2003 have started to bear fruit - High capex in 2004 (CHF51m) expected to support growth in 05/06E - CTS expects to steal market share from smaller regional players - Softlines & Hardlines (c51% of total) grew +31% & +34% y/y (organic) - We raised our 05E/06E org growth est. to +18%/+14% (from +15%/+10%)
% change vs. py	1.5%	31.0%	33.7%	32.4%	15.6%	14.0%	
Organic	12.5%	19.1%	26.0%	22.1%	18.0%	14.0%	
Currency	-4.9%	-0.2%	-6.4%	-2.6%	-4.6%	0.0%	
M&A (absolute)	-17	15	20	35	8	0	
<b>Systems &amp; Serv. Cert.</b>	<b>230</b>	<b>114</b>	<b>121</b>	<b>235</b>	<b>248</b>	<b>273</b>	- Excluding the impact from transition to the ISO 9000: 2000 standard, the division reported an organic sales growth rate of +10% y/y - We expect growth for 2005 to be driven predominantly by non-ISO 9000 activities and forecast growth to accelerate in 2006 again as the 3-year renewal period for ISO 9000 draws to an end
% change vs. py	8.0%	8.3%	-2.5%	2.5%	5.6%	10.0%	
Organic	13.3%	7.4%	0.9%	3.9%	8.0%	8.0%	
Currency	-5.3%	0.9%	-3.4%	-1.4%	-2.4%	0.0%	
<b>Industrial Services</b>	<b>330</b>	<b>182</b>	<b>198</b>	<b>380</b>	<b>411</b>	<b>444</b>	- Owing to the fact that the Industrial Services division addresses such a broad market, it is difficult to attribute the impressive growth to one or two individual sub-segments. We believe that the division's outperformance is a result of market share gains in a highly fragmented market. According to management, acquisitions are expected in this division
% change vs. py	3.0%	14.9%	15.2%	15.1%	8.3%	8.0%	
Organic	3.4%	12.7%	17.8%	15.1%	10.0%	8.0%	
Currency	-1.2%	2.1%	-2.6%	-0.1%	-1.7%	0.0%	
<b>Environmental Services</b>	<b>172</b>	<b>97</b>	<b>111</b>	<b>209</b>	<b>228</b>	<b>246</b>	- Although previously earmarked as a potential divestment candidate, the division reported encouraging organic growth throughout 2004 - Growth in 2005/6E should be supported by the expansion of new laboratories in India, China and Korea during 2004
% change vs. py	5.8%	26.4%	19.0%	21.3%	9.1%	8.0%	
Organic	6.2%	11.2%	7.8%	9.2%	8.0%	8.0%	
Currency	-1.4%	3.3%	-3.7%	-0.1%	-1.7%	0.0%	
M&A (absolute)	2	7	14	21	6	0	
<b>Automotive Services</b>	<b>211</b>	<b>89</b>	<b>99</b>	<b>188</b>	<b>206</b>	<b>222</b>	- Although the business is still impacted from the depressed American off-lease and auctions market, statutory inspections appears to be performing well and has significant growth potential in several countries due to privatisation (USA, Denmark, Brazil, India, China & Columbia) - Sales momentum should improve into 2005 resulting from the roll-out of new contract wins during 2004.
% change vs. py	-11.7%	-20.5%	-0.4%	-11.0%	9.6%	8.0%	
Organic	-3.3%	-17.9%	-8.8%	-13.4%	8.0%	8.0%	
Currency	-8.4%	-3.2%	-6.0%	-4.0%	-5.3%	0.0%	
M&A (absolute)	0	0	14	14	13	0	
<b>TAS</b>	<b>220</b>	<b>133</b>	<b>122</b>	<b>255</b>	<b>275</b>	<b>302</b>	- The shift in focus to non-PSI from PSI is supporting momentum as non-PSI is seeing accelerating growth (UBSe 40/60% for non-PSI vs PSI). TAS was previously regarded as an annuity-type business, however, we believe this division should report double-digit organic growth into 05/6E
% change vs. py	4.7%	37.5%	-0.3%	16.4%	7.6%	10.0%	
Organic	5.5%	37.7%	0.7%	17.0%	10.0%	10.0%	
Currency	-0.8%	-0.2%	-1.0%	-0.7%	-2.4%	0.0%	

CHFm	2003	H1 04	H2 04	2004	2005E	2006E	Comment
<b>Total Sales</b>	<b>2,455</b>	<b>1,390</b>	<b>1,495</b>	<b>2,885</b>	<b>3,130</b>	<b>3,410</b>	- We expect the robust organic growth momentum to continue into 2005/6E
% change vs. py	2.6%	18.4%	16.8%	17.5%	8.5%	8.9%	- We are assuming a US\$/CHF average rate of 1.17 for 2005
organic	7.0%	10.2%	11.3%	10.7%	10.2%	8.9%	- Although we do not forecast "future potential bolt-on acquisitions", we definitely expect M&A activity to continue. Assuming SGS were to spend its entire net cash position (CHF438m) in 2005 @ price/sales multiples of 1.0-1.5x, this could add as much as 9-15% in FY 05 sales
currency	-4.5%	0.7%	-4.2%	-1.8%	-2.9%	0.0%	
M&A	0.2%	7.5%	9.7%	8.6%	1.2%	0.0%	

Source: UBS estimates; SGS

**Table 4: Divisional profit (EBITA) forecasts**

CHFm	2003	H1 04	H2 04	2004	2005E	2006E	Comment
<b>Agricultural Services</b>	<b>24.3</b>	<b>9.7</b>	<b>13.9</b>	<b>23.6</b>	<b>30.9</b>	<b>36.0</b>	- The low H1 04 margin was due to the weak crop in 2003 and also reflected the impact restructuring measures/costs. Although the margin recovered significantly in H2 04, management has indicated that margins should see a "substantial improvement in 2005 " as restructuring benefits filter through
EBITA margin	10.0%	7.8%	10.5%	9.2%	11.5%	12.5%	
<b>Minerals Services</b>	<b>35.5</b>	<b>21.4</b>	<b>24.9</b>	<b>46.3</b>	<b>53.4</b>	<b>55.8</b>	- Margins expanded in 2004 due to a favourable commodities environment but also as a result of a shift towards higher value added services vs. pure inspection. We forecast margins to expand further in 2005E but then stabilise in 2006E at a 15% level (above management's previous 2005 target of 14%)
EBITA margin	12.7%	14.2%	14.8%	14.5%	15.5%	15.0%	
<b>Oil, Gas &amp; Chemicals</b>	<b>47.9</b>	<b>33.7</b>	<b>34.9</b>	<b>68.6</b>	<b>79.8</b>	<b>89.5</b>	- Although there was no margin expansion h/h, margins are expected to expand into 2005/6 due to: (1) continued sales momentum; (2) favourable margin mix (outsourcing vs. traditional oil inspection); and (3) utilisation of new labs in the Middle East; China and rest of Asia
EBITA margin	10.9%	11.9%	11.9%	11.9%	13.0%	13.5%	
<b>Life Sciences</b>	<b>5.9</b>	<b>5.8</b>	<b>7.0</b>	<b>12.8</b>	<b>16.5</b>	<b>19.8</b>	- We expect margins to gradually improve as the acquisitions are fully integrated
EBITA margin	10.0%	11.4%	12.6%	12.0%	14.0%	16.0%	
<b>Consumer Services</b>	<b>39.4</b>	<b>28.6</b>	<b>36.6</b>	<b>65.2</b>	<b>89.7</b>	<b>107.0</b>	- Major capex in E&E in 2004 expected to support margin expansion in 2005 - CTS expected to benefit from favourable margin mix (Softlines & Hardlines which are reporting exceptional growth earn higher relative margins)
EBITA margin	14.5%	17.3%	18.8%	18.1%	21.5%	22.5%	
<b>Systems &amp; Serv. Cert.</b>	<b>34.7</b>	<b>14.2</b>	<b>16.3</b>	<b>30.5</b>	<b>36.0</b>	<b>41.0</b>	- The drop in margins in 2004 was due to SGS underestimating the impact of the declining sales into 2004 following the ISO 9000: 2000 upgrade in 2003. Restructuring measures were taken in 2004 and therefore, we should see a positive margin impact into 2005/6E
EBITA margin	15.1%	12.4%	13.4%	13.0%	14.5%	15.0%	
<b>Industrial</b>	<b>34.9</b>	<b>21.0</b>	<b>25.1</b>	<b>46.1</b>	<b>55.5</b>	<b>62.2</b>	- Given the limited visibility regarding this division and the fact that we have seen an improving performance to date, we assume margins should expand to management's 14% target
EBITA margin	10.6%	11.5%	12.7%	12.1%	13.5%	14.0%	
<b>Environmental</b>	<b>11.2</b>	<b>6.4</b>	<b>10.4</b>	<b>16.8</b>	<b>25.0</b>	<b>32.0</b>	- The re-organisation of the European network into a regional structure is improving utilisation rates and should support margin expansion into 2005/6E - Restructuring measures are being taken on loss-making operations
EBITA margin	6.5%	6.6%	9.3%	8.1%	11.0%	13.0%	
<b>Automotive</b>	<b>20.8</b>	<b>9.8</b>	<b>10.2</b>	<b>20.0</b>	<b>24.7</b>	<b>28.9</b>	- As the new contract wins start to ramp-up, this should have a positive impact on margins into 2004/5E
EBITA margin	9.9%	11.0%	10.3%	10.7%	12.0%	13.0%	
<b>TAS</b>	<b>45.1</b>	<b>29.9</b>	<b>31.6</b>	<b>61.5</b>	<b>68.7</b>	<b>75.5</b>	- We believe that the TAS margin has the potential to expand significantly, however, given that this would create certain problems with regards to its competitive position and relationships with customers, we expect the focus for TAS to shift towards growth with margins likely to remain around 25%
EBITA margin	20.5%	22.5%	25.8%	24.1%	25.0%	25.0%	
<b>Total EBITA</b>	<b>299.7</b>	<b>180.5</b>	<b>210.9</b>	<b>391.4</b>	<b>480.2</b>	<b>547.6</b>	- We now assume that SGS will only reach the 16% margin level by 2006E (previously assumed by 2005E)
EBITA margin	12.2%	13.0%	14.1%	13.6%	15.3%	16.1%	

Source: UBS estimates; SGS

## Valuation and Conclusion

We derive our valuation for SGS using a DCF analysis. Our main assumptions are as follows:

- Mid-term growth rate of 6.5% (2006-14E)
- Sustainable mid-term EBITA margin of 15.5% (previously assumed 16.0%)
- Long-term growth rate of 2.0%
- WACC of 9.0%

We have slightly adjusted our capex and depreciation assumptions taking into account higher than expected capex and depreciation for FY 2004. Given the significant improvement made with respect to net working capital during 2004, specifically with respect to accounts receivable days outstanding (CerTIVVA), we have also lowered our NWC/Sales ratio to 9.0% (previously 10.0%). Taking into account the changes mentioned above, our DCF valuation now implies a value per share of CHF875 (previously CHF860).

Chart 4: DCF valuation

CHFm	2001	2002	2003	2004	2005E	2006E	2007E	2008E	2009E	2010E	2011E	2012E	2013E	2014E
Sales	2,332	2,392	2,454	2,885	3,130	3,410	3,631	3,867	4,119	4,386	4,672	4,975	5,299	5,643
growth, %		2.6%	2.6%	17.6%	8.5%	8.9%	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%
EBITA	145	216	300	391	480	548	563	599	638	680	724	771	821	875
EBITA margin	6.2%	9.0%	12.2%	13.6%	15.3%	16.1%	15.5%	15.5%	15.5%	15.5%	15.5%	15.5%	15.5%	15.5%
growth, %		49.2%	39.1%	30.3%	22.8%	14.0%	2.8%	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%	6.5%
Less: Taxes	-38	-38	-62	-89	-113	-129	-141	-150	-160	-170	-181	-193	-205	-219
Tax Rate	26.4%	17.5%	20.6%	22.7%	23.5%	23.5%	25.0%	25.0%	25.0%	25.0%	25.0%	25.0%	25.0%	25.0%
NOPLAT	106	178	238	302	367	419	422	450	479	510	543	578	616	656
Add: Depreciation	102	95	96	115	128	140	138	149	158	168	179	191	203	217
% of sales	4.4%	4.0%	3.9%	4.0%	4.1%	4.1%	3.8%	3.8%	3.8%	3.8%	3.8%	3.8%	3.8%	3.8%
Gross Cash Flow	209	273	334	417	495	559	560	598	637	678	722	769	819	873
Less: Capex	-117	-106	-171	-200	-182	-172	-174	-179	-185	-190	-196	-202	-208	-214
% of sales	-5.0%	-4.4%	-7.0%	-6.9%	-5.8%	-5.0%	-4.8%	-4.6%	-4.5%	-4.3%	-4.2%	-4.1%	-3.9%	-3.8%
NWC	286	216	196	218	270	303	327	348	371	395	420	448	477	508
NWC/Sales	12.3%	9.0%	8.0%	7.6%	8.6%	8.9%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%	9.0%
Increase in NWC	147	70	20	-22	-51	-33	-24	-21	-23	-24	-26	-27	-29	-31
Free cash flow	239	237	183	195	262	353	362	398	430	464	501	540	583	628
growth, %		-0.8%	-22.8%	6.4%	34.3%	34.8%	2.6%	9.7%	8.1%	8.0%	7.9%	7.9%	7.8%	7.7%

Valuation		Assumptions		WACC Computation	
NPV of Terminal value	3,922	WACC	9.0%	Risk free rate	4.0%
NPV of cash flows	2,750	Terminal growth	2.0%	Beta	1.10
Enterprise Value	6,672			Equity risk premium	4.5%
Add: Average net cash 2005	506			<b>Cost of equity</b>	<b>9.0%</b>
Less: Provisions	- 61			Pre-tax cost of debt	6.0%
Add: Peripherals	7			Tax-rate	23.5%
Less: Minority interest	- 280			<b>Post-tax cost of debt</b>	<b>4.6%</b>
Equity Value	6,845			Debt/Total Capital	0.0%
# of shares	7.82			<b>WACC</b>	<b>9.0%</b>
Price per share	875				

Source: UBS estimates

Based on our estimates, SGS is trading broadly in-line with Intertek (slight 5% premium to Intertek on a 2006E PE basis). We continue to believe that since there are sufficient arguments to justify both a premium and discount valuation between the two companies, and the fact that both companies are expected to deliver double-digit EPS growth into 2005/6E, we believe an in-line valuation is appropriate.

Table 5: Valuation comparisons between SGS and Intertek

At current prices	2004	2005E	2006E
PE - SGS	21.8x	17.9x	15.7x
PE - Intertek	21.0x	18.0x	15.0x
% (discount)/premium to Intertek	4%	-1%	5%
EV/EBITA - SGS	15.8x	12.9x	11.1x
EV/EBITA - Intertek	15.9x	13.7x	11.3x
% (discount)/premium to Intertek	-1%	-6%	-2%
At price targets	2004	2005E	2006E
PE - SGS	23.4x	19.3x	16.9x
PE - Intertek	23.3x	20.0x	16.7x
% (discount)/premium to Intertek	0%	-4%	1%
EV/EBITA - SGS	17.0x	13.9x	11.9x
EV/EBITA - Intertek	17.4x	15.0x	12.4x
% (discount)/premium to Intertek	-2%	-7%	-4%

Source: UBS estimates

At our price targets, both SGS and Intertek trade on a c17x PE multiple for 2006E. While we acknowledge that a 17x PE multiple appears demanding, we believe this is justified for the following reasons:

- We forecast SGS to deliver an EPS CAGR of +17.6% over the next 2 years (Intertek at 18.2%)
- SGS is fairly non-cyclical and therefore the potential for significant downside risk to our estimates, specifically in SGS's case, is extremely low, in our opinion
- SGS's balance sheet is solid, with a net cash position of CHF438m at FY 04 and equity ratio of 56%
- Given that management have indicated that their acquisition pipeline is full, we expect SGS to make several bolt-on acquisitions within the next 2 years, potentially using its entire net cash position. Similar to the recent acquisitions, we expect substantial EPS enhancements from these acquisitions.

Although we believe SGS's outlook remains promising, given the recent share outperformance, we see limited upside potential to our CHF875 PT. We therefore cut our rating to Neutral 1 from Buy 1. We expect the share momentum to be driven by 3 factors within the next few months: (1) investors' perception of the new CEO; (2) level of M&A activity; and (3) organic growth and margin progression in the H1 04 results (due July 13<sup>th</sup>, 2005).

## ■ **SGS**

SGS is the largest inspection, testing and certification organisation in the world. The core services offered by SGS (split between 10 divisions) can be divided into three categories: (1) inspection services - SGS inspects and verifies the quantity, weight and quality of traded goods; (2) testing services - SGS tests product quality and performance against various health, safety and regulatory standards; and (3) certification services - SGS certifies that systems or services meet the requirements of standards set by governments, standardisation bodies or by SGS customers.

## ■ **Statement of Risk**

A weakening US dollar is likely to result in downside risk to our estimates given SGS's US dollar translation exposure of between 40-45%.

## ■ **Analyst Certification**

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UBS rating	Definition	UBS rating	Definition	Rating category	Coverage <sup>1</sup>	IB services <sup>2</sup>
<b>Buy 1</b>	FSR is > 10% above the MRA, higher degree of predictability	<b>Buy 2</b>	FSR is > 10% above the MRA, lower degree of predictability	<b>Buy</b>	36%	32%
<b>Neutral 1</b>	FSR is between -10% and 10% of the MRA, higher degree of predictability	<b>Neutral 2</b>	FSR is between -10% and 10% of the MRA, lower degree of predictability	<b>Hold/Neutral</b>	53%	35%
<b>Reduce 1</b>	FSR is > 10% below the MRA, higher degree of predictability	<b>Reduce 2</b>	FSR is > 10% below the MRA, lower degree of predictability	<b>Sell</b>	11%	29%

1: Percentage of companies under coverage globally within this rating category.

2: Percentage of companies within this rating category for which investment banking (IB) services were provided within the past 12 months.

Source: UBS; as of 31 December 2004.

### KEY DEFINITIONS

**Forecast Stock Return (FSR)** is defined as expected percentage price appreciation plus gross dividend yield over the next 12 months.

**Market Return Assumption (MRA)** is defined as the one-year local market interest rate plus 5% (an approximation of the equity risk premium).

**Predictability Level** The predictability level indicates an analyst's conviction in the FSR. A predictability level of '1' means that the analyst's estimate of FSR is in the middle of a narrower, or smaller, range of possibilities. A predictability level of '2' means that the analyst's estimate of FSR is in the middle of a broader, or larger, range of possibilities.

**Under Review (UR)** Stocks may be flagged as UR by the analyst, indicating that the stock's price target and/or rating are subject to possible change in the near term, usually in response to an event that may affect the investment case or valuation.

**Rating/Return Divergence (RRD)** This qualifier is automatically appended to the rating when stock price movement has caused the prevailing rating to differ from that which would be assigned according to the rating system and will be removed when there is no longer a divergence, either through market movement or analyst intervention.

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### Companies mentioned

Company Name	Reuters	Rating	Price
<b>Intertek Group plc</b> <sup>2,4a</sup>	ITRK.L	Buy 1 (RRD)	720p
<b>SGS</b> <sup>4b,5</sup>	SGSN.VX	Neutral 1	CHF813.50

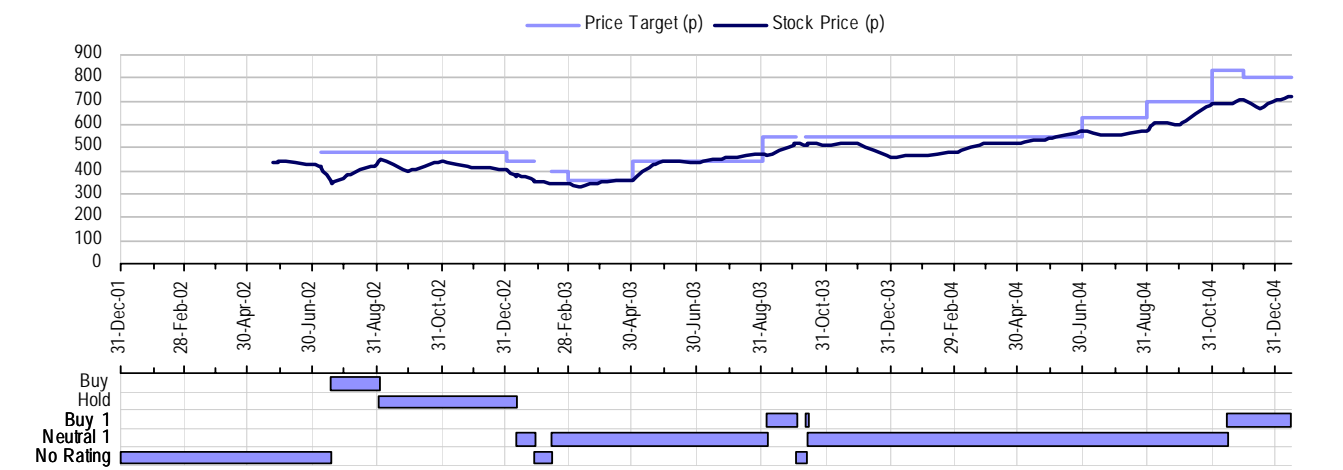
Price(s) as of 14 January 2005. Source: UBS.

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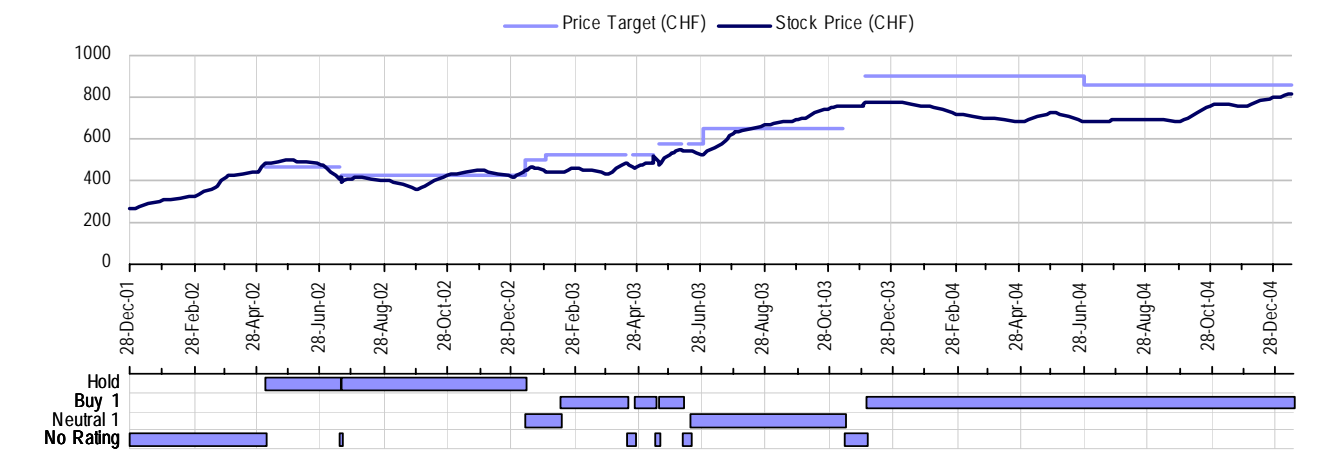
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Unless otherwise indicated, please refer to the Valuation and Risk sections within the body of this report.

**Intertek Group plc (p)**



**SGS (CHF)**



Source: UBS; as of 14 January 2005.

Note: On October 13, 2003, UBS adopted new definition criteria for its rating system. (See 'UBS Investment Research: Global Equity Ratings Definitions and Allocations' table for details.) Between January 11 and October 12, 2003, the UBS ratings and their definitions were: Buy 1: Excess return potential > 15%, smaller range around price target; Buy 2: Excess return potential > 15%, larger range around price target; Neutral 1: Excess return potential between -15% and 15%, smaller range around price target; Neutral 2: Excess return potential between -15% and 15%, larger range around price target; Reduce 1: Excess return potential < -15%, smaller range around price target; Reduce 2: Excess return potential < -15%, larger range around price target. Prior to January 11, 2003, the UBS ratings and definitions were: Strong Buy: Greater than 20% excess return potential, high degree of confidence; Buy: Positive excess return potential; Hold: Low excess return potential, low degree of confidence; Reduce: Negative excess return potential; Sell: Greater than 20% negative excess return potential, high degree of confidence. Under both ratings systems, excess return is defined as the difference between the FSR and the one-year local market interest rate.

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**Head Office:** UBS Limited, 1 Finsbury Avenue, London, EC2M 2PP, UK Phone: +44-20-7567 8000

**Local Office:** UBS Limited, Europastrasse 1, CH-8152 Opfikon Phone: +41-1-238 1111

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