

FY 2007 results: ahead of expectations

SGS reported FY 2007 sales of 4.32 bn, growth of 14.4% over the prior year, of which 12% organic. Operating profit of CHF 711 mn (excluding restructuring charges) rose 18% over the prior year and represents an operating margin of 16.3%, up 50 bps in FY 2007 and up 60 bps in H2. Adjusted net income of CHF 515 mn represents an increase of 20% over 2006, and is 5% above our forecast.

COMPARISON OF ACTUAL VS ESTIMATED RESULTS

FY 2007 results		2006	2007	Growth	2007E	Delta
Revenues	CHF mn	3,821	4,372	14.4%	4,314	1.3%
% growth		15.5%	14.4%		12.9%	
Operating Income	CHF mn	624	690	10.6%		
% of net sales		16.3%	15.8%			
Operating Profit (adj)	CHF mn	605	711	17.5%	688	3.3%
Operating profit margin		15.8%	16.3%		15.9%	
Net profit	CHF mn	443	500	12.9%	489	2.2%
Net profit (adj)	CHF mn	431	515	19.5%	489	5.3%

Source: SGS and Vontobel Equity Research

Highest ever organic growth

The key performance metric, in our view, is the stronger-than-expected organic growth rate of 12% for the year, the highest figure the company has ever reported, and represents the fourth consecutive year of double-digit organic growth as well as an average of 11% over four years. This rate compares favourably to the sector, which we estimate has an underlying growth of 7-8%. Bureau Veritas posted organic growth of 9% YTD and Intertek 7.4%.

All SGS divisions contributed positively to this growth, with seven of ten divisions reporting internal growth in excess of 10%.

Operating margin up 50 bps to 16.3%

The operating profit of CHF 711 mn represents an operating margin of 16.3% for FY 2007, also a record result (however, excluded from this result is the CHF 21 mn restructuring charge, which will result in a permanent reduction in back office headcount, and will be recovered over 18 months). The adjusted operating margin represents an increase of 50 bps over the prior year. The improvement in the operating margin accelerated in the second half of the year, up 60 bps in H2 vs. 20 bps in H1. All divisions contributed to the increase in operational profit, with eight of ten divisions posting an increase in the operating margin.

SGS group operating margin is about 100 bps above that of both Bureau Veritas and Intertek.

Dividend increased 75%

SGS announced a total dividend payment of CHF 35 per share (CHF 25 ordinary plus CHF 10 as a special dividend), up 75% over the prior year and representing a dividend ratio of about 3% this year. The total dividend payout will be CHF 266 mn, consuming roughly two thirds of the company's CHF 400 mn net cash as of end of year 2007.

The increased payout this year is consistent with our understanding of the company's goal to keep the balance sheet neither positively nor negatively geared. SGS previously indicated that in years in which its operating cashflow is not fully invested (through internal capital expenditures or for M&A) the excess would be returned to shareholders.

The decision to pay out a special dividend also reflects the board's confidence in the company's balance sheet and strong future cash flow generation capacity.

New financial targets

SGS announced a new four-year EPS target of CHF 105 by 2011, equal to a CAGR of 12% over 2007-2011.

The previous EPS target of CHF 80 for 2008 is maintained and, if attained, would trigger vesting of the stock options linked to the long-term incentive plan. However, this plan has been extended to also allow the possibility of a partial vesting in 2009, in the event that the CHF 80 is not met in 2008. The plan would now vest at 60% if CHF 80 is attained by 2009, increased to 100% for EPS in excess of CHF 84.

Our forecasts, assuming no additional acquisitions, pencil in EPS of CHF 74.4 2008E and CHF 82.5 2009E, which would yield 80% vesting of the LTI plan in 2009.

We believe the board of directors has agreed to extend the plan timeline in recognition that management is largely on track for the 2005-2008 business plan in terms of organic growth (over 10% per annum) and operating margin progression (trending towards the 17% operating margin goal) and that the relative lack of acquisitions in 2007 reflects in part a changed external environment characterized by higher M&A transaction prices and the decision by the board of directors to not overspend in making deals.

Outlook

Management's outlook for 2008 is for continued double-digit organic growth and further margin expansion, both of which are reflected in our forecasts.

The results by division are shown on the table on page 6 below, along with our key assumptions for growth and margin development. There were no major differences in the results reported by division compared to our expectations, the key positive surprises being the higher-than-expected growth in the Industrial Services (+16%) and Government Services (+20%) segments. As mentioned above, seven of ten divisions attained organic growth in excess of 10% in 2007, all divisions contributed to the increase in operating profit.

Changes to our forecasts

We have changed our financial forecasts to take into account the better-than-expected FY 2007 results, slightly offset by the negative impact of recent currency fluctuations. The net changes to our EPS forecasts are +2% for 2008E, and +1% for 2009E.

CHANGES TO FINANCIAL FORECASTS									
In CHF mn FY to Dec. 31	new estimates			old estimates			% change		
	2007	2008E	2009E	2007E	2008E	2009E	2007	2008E	2009E
Revenues (net)	4,372	4,762	5,213	4,314	4,750	5,180	1.3%	0.3%	0.6%
EBITDA	908	1002	1109	878	990	1,104	3%	1%	0%
Operating Profit	690	787	874	688	783	878	0%	1%	0%
Operating Profit margin	15.8	16.5	16.8	16.0	16.5	16.9			
Net profit	500	571	636	489	558	627	2%	2%	1%
Net profit (adjusted)	515	571	636	489	558	627	5%	2%	1%
EPS (adjusted)	67.4	74.4	82.5	63.9	72.6	81.3	6%	2%	1%

Source: Vontobel Equity Research

Valuation

The valuation of SGS at 17.4x FWD PE and 11.6x FWD EV/EBIT remains low compared to its historical averages of 19x and 13.7x, respectively. We also note that SGS is trading at a discount to its listed peers on EV/EBIT and EV/EBITDA multiples and at only a small premium on PE, a valuation we find surprisingly low given SGS's higher organic growth and operating margins.

PEER GROUP VALUATION COMPARISON													
Company	Curr.	Price as of 16-01-08	Market cap. in EUR mns	Perf. YTD	PE			EV/EBIT			EV/EBITDA		
					2007	2008E	2009E	2007	2008E	2009E	2007	2008E	2009E
SGS	+ CHF	1,291	6,150	-4.3	19.7	17.4	15.7	13.3	11.6	10.5	10.3	9.1	7.7
Bureau Veritas	EUR	31.8	3,785	-21.4	19.2	15.3	13.1	14.6	12.2	10.8	12.8	10.7	9.6
Intertek Group	GBP	891	1,913	-10.0	18.5	16.2	13.9	14.0	12.0	10.4	11.0	9.5	8.1
- Average					19.1	16.3	14.3	14.0	12.0	10.6	11.4	9.8	8.5
SGS vs Average					3%	7%	10%	-5%	-3%	-1%	-9%	-6%	-9%

Source: JCF and Vontobel Equity Research

How sensitive is SGS to global economy?

The recent decline in share indices generally reflects increased concerns that global economic growth may falter, particularly if the US goes into a recession as this would have the potential to drag the rest of the world down with it.

SGS is often perceived, incorrectly in our view, as a proxy for global economic growth. This perception stems from SGS's historical exposure to global trade and the pre-shipment inspection of exports. Over the last five years, SGS has rebalanced its exposure away from trade-volume related inspection services and more towards laboratory testing and increasingly high value-added analysis and consulting services. This broadening of services offered to SGS's clients is one of the reasons for the high and sustained growth over the last several years, over and above the market growth.

We believe that SGS has the potential to continue growing revenues despite increased concerns of an economic downturn due to the nature of many of its business lines, which are not related to trade volumes. If we take for example the testing of consumer goods, we see that SGS's revenues are more linked to the number of different product lines tested than to the volume of goods

purchased by consumers. Assume that US consumers purchase fewer mobile phones, causing a drop in a 10% production of handsets. However the demand for SGS services would remain constant even in such a case, as SGS's clients need testing and certification of each model produced, unless certain handset models are withdrawn from the market.

Other business lines, such as statutory automotive emissions inspection and environmental testing, are mandated by law, and are not likely to rise or fall with consumer demand.

Finally, the segments of Minerals and Oil and Gas are driven more by shortages in raw material resources and high commodities prices, which are spurring increased exploration and extraction, trends which are likely to continue even if the economy is sluggish.

So, while SGS does have some GDP exposure, mostly in the agricultural services division to volume related trade, the company is less geared to the economy than in the past, and has multiple segments with opportunities for growth that are independent of the overall economic cycle.

Conclusion

SGS has the highest organic growth rate in the industry compared to its major peers. We believe there are further opportunities for sustained growth in sales and expansion in margins in all divisions on the back of ongoing favourable sector developments (increased customer willingness to outsource non-core testing activities, increased environmental and safety concerns and regulations, increased delocalization of production, scarcity of energy commodities) as well as SGS's sustained success in moving up the value chain by offering higher value-added services.

We continue to believe that the outlook for continued strong organic growth and further operating margin development is positive for SGS and therefore reiterate both our Buy rating and 12-month price target of CHF 1,580.

RESULTS AND FORECASTS BY DIVISION

Divisional Revenue Breakdown

Division		2004	2005	2006	2007	2008E	2009E
Agricultural Services	CHF mn	257	295	317	357	382	408
Minerals Services	CHF mn	319	394	467	560	624	699
Oil, Gas & Chemicals Services	CHF mn	575	635	783	891	958	1045
Consumer Testing Services	CHF mn	361	476	593	655	730	832
Systems & Services Certification	CHF mn	235	274	319	354	380	411
Government Services	CHF mn	255	229	169	200	206	216
Automotive Services	CHF mn	188	200	220	249	258	271
Life Sciences Services	CHF mn	107	125	193	200	210	224
Industrial Services	CHF mn	380	445	510	625	718	790
Environmental Services	CHF mn	209	235	249	281	297	318
Total revenues	CHF mn	2885	3308	3821	4372	4762	5213

Divisional Revenue Breakdown (yearly organic change in %)

Division		2004	2005	2006	2007	2008E	2009E
Agricultural Services	%	7.4	12.2	7.5	4.2	6.0	7.0
Minerals Services	%	16.4	17.1	13.3	17.3	14.0	12.0
Oil, Gas & Chemicals Services	%	12.8	9.5	11.0	12.5	10.0	9.0
Consumer Testing Services	%	22.8	27.2	22.0	10.3	14.0	14.0
Systems & Services Certification	%	3.9	15.3	14.9	9.2	10.0	8.0
Government Services	%	17.2	-10.5	-26.1	19.8	5.0	5.0
Automotive Services	%	-14.0	-0.5	4.0	10.3	6.0	5.0
Life Sciences Services	%	-4.2	15.6	9.1	4.3	7.0	7.0
Industrial Services	%	15.2	12.6	13.1	16.0	13.0	10.0
Environmental Services	%	9.3	9.0	6.3	13.8	8.0	7.0
Total revenues	%	10.7	11.3	10.2	12.1	10.1	9.5

Divisional Operating Profit Margin Breakdown

Division		2004	2005	2006	2007	2008E	2009E
Agricultural Services	%	9.2	11.4	12.4	13.4	13.5	13.5
Minerals Services	%	14.5	16.0	17.2	17.5	17.5	17.5
Oil, Gas & Chemicals Services	%	11.9	12.5	14.4	15.0	15.0	15.0
Consumer Testing Services	%	18.1	21.4	23.1	23.2	23.5	24.0
Systems & Services Certification	%	13.0	17.0	18.5	18.4	18.5	18.5
Government Services	%	24.1	21.2	13.7	14.4	15.0	15.0
Automotive Services	%	10.7	12.6	13.5	13.6	13.5	13.5
Life Sciences Services	%	12.0	15.2	12.7	12.0	13.0	14.0
Industrial Services	%	12.1	13.2	14.6	16.1	16.5	16.5
Environmental Services	%	8.1	11.1	9.7	9.8	10.0	10.5
Total operating income	%	13.6	15.2	15.8	16.3	16.5	16.8

Source: Company data and Vontobel Equity Research

SGS

17-01-08

CONSOLIDATED FINANCIAL DATA (CHF MNS)

	2005	2006	2007	2008E	2009E	2010E	2011E
REVENUES	3,308	3,821	4,372	4,762	5,213	5,710	6,259
- change (%)	15	16	14	9	9	10	10
EBITDA	642	781	908	1002	1109	1220	1343
- change (%)	27	22	16	10	11	10	10
- as % of revenues	19.4	20.4	20.8	21.0	21.3	21.4	21.5
DEPRECIATION	-140	-176	-197	-215	-235	-257	-282
- as % of revenues	4.2	4.6	4.5	4.5	4.5	4.5	4.5
EBITA BEF. E.O. ITEMS	502	605	711	787	874	963	1061
- change (%)	28	20	18	11	11	10	10
- as % of revenues	15.2	15.8	16.3	16.5	16.8	16.9	17.0
E.O. ITEMS	0	19	-21	0	0	0	0
EBITA	502	624	690	787	874	963	1061
- change (%)	27	24	11	14	11	10	10
- as % of revenues	15.2	16.3	15.8	16.5	16.8	16.9	17.0
GOODWILL AMORTISATION	0	0	0	0	0	0	0
EBIT	502	624	690	787	874	963	1061
- change (%)	27	24	11	14	11	10	10
- as % of revenues	15.2	16.3	15.8	16.5	16.8	16.9	17.0
FINANCIAL RESULT	5	-1	2	5	8	11	14
PRETAX PROFIT	507	623	692	792	882	974	1075
- change (%)	32	23	11	15	11	10	10
- as % of revenues	15.3	16.3	15.8	16.6	16.9	17.1	17.2
TAXES	-119	-155	-172	-198	-220	-243	-269
- tax rate (%)	23	25	25	25	25	25	25
GROUP NET PROFIT	388	468	520	594	661	730	806
- change (%)	33	21	11	14	11	10	10
- as % of revenues	11.7	12.2	11.9	12.5	12.7	12.8	12.9
MINORITY INTERESTS	-17	-25	-20	-23	-25	-28	-31
SHAREHOLDERS' NET PROFIT	371	443	500	571	636	702	775
- change (%)	34	19	13	14	11	10	10
- as % of equity shareholder	25.8	28.7	26.2	24.6	23.6	22.1	20.9
CASH FLOW FROM OPERATIONS	411	552	685	786	870	959	1057
- change (%)	25	17	16	13	11	10	10
- as % of revenues	16.0	16.2	16.4	17.0	17.2	17.3	17.4
CAPITAL EXPENDITURES	-205	-224	-271	-298	-328	-361	-397
-5-year average	-163	-184	-214	-240	-265	-296	-331
DATA PER REGISTERED (CHF, ADJ)							
EARNINGS	48.8	58.4	65.5	74.4	82.5	90.7	99.8
- change (%)	35	20	12	14	11	10	10
CASH EARNINGS PER SHARE	48.8	58.4	65.5	74.4	82.5	90.7	99.8
DIVIDEND	50.0	18.0	20.0	35.0	28.0	32.0	35.0
- payout ratio (%)	102	31	31	47	34	35	35
CASH FLOW	54	73	90	102	113	124	136
BOOK VALUE	189	203	249	303	349	410	477
TOTAL ASSETS	2,765	2,852	3,333	3,756	4,151	6,523	10,786
CASH	531	239	365	590	772	1,154	1,565
NET DEBT (Cash)	-430	-215	-328	-578	-760	-1,142	-1,553
- as % of group equity	-29	-14	-17	-24	-28	-36	-42
Goodwill and Intangibles	429	644	716	736	756	1,512	3,024
EQUITY SHAREHOLDER	1,439	1,542	1,905	2,324	2,691	3,177	3,705
GROUP EQUITY	1,475	1,592	1,975	2,417	2,691	3,177	3,705
- as % of total assets	53	56	59	64	65	49	34
NO. OF REG. (MNS)	7.600	7.595	7.637	7.682	7.712	7.742	7.772

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