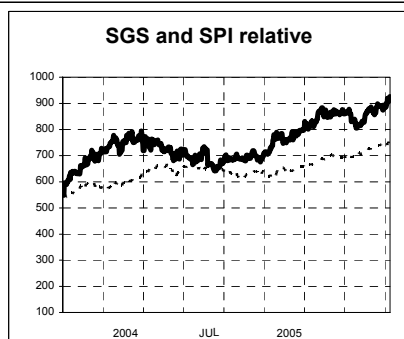


## H1 2005 results

## Convincing new CEO, strong business momentum intact, earnings and price target increases, BUY confirmed

### BUY

Market cap.	CHF m	7074	Key figures	2003	2004	2005E	2006E	2007E	CAGR
Last price	CHF	926	(CHF)						<b>02-07E</b>
52 week high	CHF	932	Net revenues (m)	2454	2885	3250	3567	3877	10.1
52 week low	CHF	671	Growth rate (%)	2.6	17.6	12.6	9.8	8.7	
YTD performance	%	16.3	EBITDA (m)	396	506	621	709	797	20.7
<b>Economic value</b>	<b>CHF</b>	<b>1046</b>	Margin (%)	16.1	17.5	19.1	19.9	20.6	
Soft factor ded.	%	0.0	EBIT (m)	290	375	493	570	649	25.7
<b>Fair value NZB</b>	<b>CHF</b>	<b>1046</b>	Margin (%)	11.8	13.0	15.2	16.0	16.7	
Div. ranking shs	m	7.6	Net profit (m)	227	279	367	426	490	35.0
Symbols	SGSN.VX, SGSN VX		Dividend	9.0	12.0	15.0	18.0	20.0	22.5



EPS revision	2003	2004	2005E	2006E	2007E	CAGR
EPS new	29.6	36.5	48.1	55.8	64.1	35.1
EPS old			46.5	54.5	62.5	
% change			3.3	2.4	2.6	

Valuation (x)	2003	2004	2005E	2006E	2007E
P / E	20.4	19.7	19.3	16.6	14.4
P / CEPS	19.5	18.6	19.3	16.6	14.4
P / BV	4.3	4.5	4.7	3.9	3.3
EV / EBITDA	13.9	11.5	10.7	8.9	7.5
Dividend yield (%)	1.5	1.7	1.9	2.2	2.5

Even if no acquisitions or no new financial targets were announced, SGS was still able to surprise the market with a robust set of H1 05 results. Moreover, the company has many promising opportunities to further grow the business internally in a very profitable way on the back of the strong momentum in the industry, as well as the success of new service/product launches. In addition, we still believe that SGS is well-placed to take part in the further consolidation of the industry. Based on our estimates, we derived that acquisitions should be value enhancing for SGS. Given its impressive financial firepower, we also think that SGS has the potential to return cash to shareholders.

**BUY rating maintained with a new price target of CHF 1040 (vs. CHF 975)**

We have made some adjustments to our earlier forecasts in that we have upgraded our EPS estimates for 2005ff by 3% on average. Our 'fair value NZB' now stands at CHF 1046 per share (vs. CHF 1013).

We came away from our first contact with the new CEO with a very good feeling. His approach seems to be very structured as well as focused on SGS' growth and future new business opportunities. Given SGS's present sound business and financial situation, Dan Kerpelman has inherited a jewel made out of rough diamonds of different quality. His job is now to bring all divisions or diamonds up to the same standard of quality, and to successfully add some new pieces to the jewel he has inherited. Given the above, and considering our estimate upgrades, we consider the stock still to be an attractive option. Considering the upside potential to our new fair value, we have set a higher price target at CHF 1040. We are sticking to our BUY rating on the SGS stock.

- **Outstanding results in the first half of 2005:** SGS had set ambitious targets for the current year. On the basis of the first half results for 2005, it looks like the company will exceed its own targets. In the first semester, SGS results were above the very demanding expectations. Thanks to a booming market in Asia, SGS achieved an impressive 11.2% organic sales growth. Five out of ten business units reported organic growth in excess of 12% (Consumer Testing 26%, Minerals 19%, Systems & Services Certification 13%, Industrial 12% and Life Science Services 18%). Trade Assurance Services was the only division to report a sales decrease. The drop in sales was mainly due to the discontinuation of contracts in Peru, Ethiopia and Burkina Faso in 2004, as well as an unfavorable baseline effect (organic growth H1 04 of 38%). The non-PSI business (around 35% of the division) achieved a solid double digit growth. Acquisitions net of disposals accounted for CHF 31m in sales at group level, or a positive impact of 2.2%, while foreign currencies had a negative impact of -1.5% (mainly due to the weaker USD).

The increase in operating profit was even more impressive at CHF 55m (+32%). The operating profit margin improved by 200bp y-o-y to 14.7% in line with our own expectations. The improvement in Consumer Testing (+400bp to 21.3%) and in Systems & Services Certification (+320bp to 15.5%) proved much better than expected. The overall increase in operating profit was primarily helped by the strong volume growth (operational leverage), the improvement in the business mix towards more upstream services, as well as synergies from past acquisitions. As we outlined in our investment case, bolt-on acquisitions have played, and will continue to play, a crucial role in SGS's development. In the first half of the year, the operating margin of the acquired companies stood at almost 17%, which is above the group average. On the other hand, the margins of the disposed businesses were very low (2%).

Net income was up 37% to CHF 170m (vs. our CHF 165m). Net financial income as well as taxes were bang in line with our expectations.

As of end June 2005, SGS had a net cash position of CHF 349m after payment of the dividend of CHF 90m and acquisitions of CHF 22m (vs. CHF 278m as of end of June 2004). The increase in net working capital (NWC) of CHF 81m was a bit higher than we expected (cash out for bonus payments, insurance, security payments incurred in the first part of the year), but also not astonishing in light of such considerable growth. However, as seen last year, we expect SGS to reduce NWC in the second semester. Management recently confirmed to us that its commitment to reduce NWC in FY 2005 was still valid. SGS continued to make sizable investments, with a significant part devoted to the Asia Pacific region, as well as to Consumer Testing, Minerals, and Automotives (new projects in Chile and in the USA). CAPEX amounted CHF 95m, and management expects to spend a similar amount in the second part of the year. Thus, CAPEX should reach around CHF 190m-200m for the current year (vs. CHF 201m last year). According to management, CAPEX should fade in future given the current capacity abroad in the different segments and labs. However, SGS's goal is to remain flexible regarding investments, and management would be ready to assess more CAPEX for a new business opportunity or growth.

- **Refreshing and expanding six sigma:** As we expected, on the back of the new CEO's former positions, SGS announced that the six sigma program has been refreshed and expanded to cover a wider array of competitive advantage initiatives. According to the new CEO, who headed up the project during his many years at GE, SGS has established a sound base for the six sigma program within the group. However, Dan Kerpelman believes that the company still has more potential thanks to six sigma. The launch of activities on a larger scale throughout the group (instead of local initiatives as has been the case so far) in order to improve, for instance, back office efficiency and lab turnaround time is imminent – as we understood from management. The new CEO has shown himself very bullish with regard to the capabilities of six sigma, especially in terms of helping SGS to be more flexible and lean in order to remain in pace with its growth path. We hope to get more details in the coming months on the different initiatives, as well as their impact on the group's performance overall (cost savings).
- **Outlook and new NZB estimates:** The least we could expect from SGS was confirmation of the CHF 45 EPS target, given the strong set of results in H1 2005 and the bullish statements for the second part of the year. Reflecting the actual figures for H1 05, as well as the outlook management gave for some of the divisions, we have adjusted our estimates. In a nutshell, our new assumptions in our financial model are:
  1. Sales: slightly higher organic growth for 2005ff (the new CEO sees no reason to become less bullish and is not giving up on double digit growth in the near future thanks to the solid performance from the emerging markets); stronger impact from acquisitions net of disposals in 2005; new foreign currency assumption (including USD/CHF 1.25 vs. 1.15), thus a negative currency impact 2005 of -0.1% vs. -2.8% previously.
  2. Overall, slightly lower operating margin for 2005ff (lower assumptions for the TAS division), but higher operating profits in absolute numbers (thanks to higher volume growth).
  3. Lower tax rate for 2005ff, based on management's guidance (around 23.5%).
  4. New assumptions for our CAPEX and depreciation estimates (both higher).

Overall, our earnings upgrades lead to an EPS increase of 3.4% in 05E, 2.4% in 06E and 2.6% in 07E.

**New vs. old key figures (estimates)**

In CHF m	FY 05E (old)	FY 05E (new)	FY 06E (old)	FY 06E (new)	FY 07E (old)	FY 07E (new)
Sales	3146	3250	3439	3567	3724	3877
Organic growth in %	11.4	11.6	9.3	9.8	8.3	8.7
Operating profit	479	493	557	570	633	649
Operating profit margin in %	15.2	15.2	16.2	16.0	17.0	16.7
Net profit	356	367	416	426	478	490
EPS in CHF	46.5	48.1	54.5	55.8	62.5	64.1

Source: company data, NZB Neue Zürcher Bank estimates

- **New financial targets set in autumn:** We were expecting the announcement of new financial targets together with the H1 05 set of results. However, the new CEO made it clear that he needs more than 100 days to set new financial targets for the mid term. According to him, it is “hard definition work” that needs some time. Together with the Operations Council, Dan Kerpelman is reviewing each business division from a new, growth perspective. Thus, even if the company is still gaining leverage, future profit improvement will mainly come from growth rather than restructuring/reshaping the business. We believe that together with the board (former CEO Sergio Marchionne is still playing an active and decisive role within SGS), Dan Kerpelman could produce a mix of quantitative and qualitative targets. SGS should be ready to give more information on these targets later in autumn this year (October or November), along possibly with a new definition of the business units.
- **Bolt-on acquisitions:** We were also a bit surprised, not to say disappointed, that SGS did not announce one or several acquisitions along with the release of H1 05 figures, the company having made only two small acquisitions for around CHF 22m to date. Back at the beginning of 2004, management set the goal of acquiring around CHF 400m per year. However, in the last 18 months, the company has spent only CHF 235m on acquisitions (out of a 'planned' CHF 600m, which makes for only 40%), while certain other competitors have been active in the M&A field (Bureau Veritas acquired no less than seven small to bigger sized companies). The new CEO has no intention of changing the company's strategy in that regard. According to him, the low activity in H1 05 was due to a lack of opportunities (right company, synergies potential) rather than a lack of interest. We think that the acquisition projects were put on hold during the management transition period. According to management, SGS has some projects in the pipeline and should announce acquisitions in the coming weeks. As far as we understand, the company is ready to target companies for bolt-on acquisitions with a size of up to CHF 150m sales. We think that SGS aims to acquire a bigger company in the Life Science Services division, and to continue to acquire smaller players to round out the current core businesses (Oil, Gas and Chemicals, Minerals, Consumer Testing among others).

- At this point, we reiterate that, according to our estimates, based on the price paid by SGS for acquisitions last year (around 1.0x sales vs. industry average of 1.2x sales), this would add roughly CHF 400m in sales, or around 10-15% top-line growth on an annual basis. Considering a 12% operating margin (vs. >15% for the past acquisitions, on average), this would add around CHF 48m in operating or CHF 32m in contributing profit (after taxes). This represents an additional CHF 4.1 per share (or 7.3%). Based on the today's multiples (P/E 06E 16.6x), this represents an additional value CHF 68 per share for the stock. The above consideration excludes synergies, which SGS was able to generate with past bolt-on acquisitions, as the company's main goal is to deploy the services offered by the potential target to the whole SGS network, thus leveraging the operating performance. The CHF 4.1 additional EPS should be seen against the CHF 6m to CHF 7m that SGS could earn from its net cash position (or CHF 0.9 additional EPS). We derived three different scenarios (from the most optimistic one). Each of them supports the notion that the company has the potential to create more value through acquisitions than with the existing balance sheet structure. This also shows that SGS has the opportunity to grow the business in a profitable way both with internal and external sources.

**Value-enhancing acquisitions (purchase price CHF 400m)**

In CHF m	Scenario 1	Scenario 2	Scenario 3
Sales	570	400	330
Price/sales	0.7x	1.0x	1.2x
Operating profit margin	12%	12%	12%
Operating profit	68	48	40
EV/EBITA	5.9x	8.3x	10.0x
Financial result on net cash CHF 400m @ 1.5%	6	6	6
Taxes (tax rate on EBT @ 25%)	15.5	10.5	8.5
Contributing profit	46.5	31.5	25.5
Contributing EPS in CHF	6.1	4.1	3.4
Contributing EPS in % (basis 2006, EPS CHF 55.8)	10.9	7.3	6.0

Source: company data, NZB Neue Zürcher Bank estimates

- Sound financial situation will facilitate cash payback to shareholders:** With an equity ratio of nearly 60%, SGS has a very sound, albeit under-leveraged, balance sheet. The company should have a net cash position of more than CHF 500m at year end, and plans to spend around CHF 200m in CAPEX annually, and a further CHF 400m on acquisitions. However, as SGS generates around CHF 250-300m in operating free cash flow per year, it should continue to enjoy a comfortable cash position in the coming years. Considering the limited probability of a larger acquisition in the near term (Bureau Veritas, Intertek), and the relatively low dividend yield, the likelihood of the company returning cash to shareholders in the coming years (in a form to be defined by the board) is increasing. The following table shows, although on a very theoretical basis, that SGS could give around CHF 250m back to shareholders per year on average (assumption: no acquisition, cushion net cash of CHF 400m). This also illustrates that SGS has many alternatives in place to better leverage its balance sheet, and thus create shareholder value as well.

**Potential for further cash return  
in CHF m**

	2005E	2006E	2007E
Opening net cash	438	632	874
Closing net cash	632	874	1157
Cash for acquisitions	400	400	400
Potential for cash return (cum.)	232	474	757
Potential for cash return (annual)	238	243	283
Cash return per share (in CHF)	31.2	31.8	37
Recurring dividend per share (in CHF)	15.0	18.0	20.0
Total dividend per share potential (in CHF)	46.2	49.8	57.0
Cash yield (in %)	5.1	5.5	6.3

Source: company data, NZB Neue Zürcher Bank estimates

- Valuation:** Based on our estimates, SGS is trading at a P/E 06E of 16.6x and an EV/EBITDA 06E of 8.9x. This valuation is at a slight premium (around 2%) to the group's competitor Intertek (vs. a slight discount of 7-8% previously), given the weak performance of Intertek since their last trading statement at the end of June. We would still consider a premium of around 10% versus Intertek justifiable (better business mix, gaining market shares in Consumer Testing and in OGC, higher operating margin improvement potential).

We also carried out a second, broader valuation comparison of SGS to a group of European service companies. It shows that SGS's valuation has a premium of around 15-20%. In view of the highly cyclical character of several companies in this group, and the questionable earnings quality of certain firms, we are of the opinion that SGS likewise deserves a higher premium to this group.

**Valuation Comparison**

Company	Currency	Share price	Market Cap in m in local curr.	P/E 2005E	P/E 2006E	EV/EBITDA 2005E	EV/EBITDA 2006E
SGS	CHF	919	7017	19.3x	16.6x	10.7x	8.9x
Intertek Group	GBP	715	1099	18.1x	15.8x	10.6x	9.1x
Securitas	SEK	138	47839	17.5x	15.7x	9.4x	8.4x
Rentokil Initial	GBP	159	2878	12.7x	12.0x	7.4x	7.1x
Compass Group	GBP	240	5195	11.8x	10.9x	6.9x	6.4x
Sodexo Alliance	EUR	27.8	4421	15.4x	14.3x	6.6x	6.0x
Randstad	EUR	31.8	3676	16.2x	13.7x	10.2x	8.2x
Vedior	EUR	12.4	2060	14.6x	11.8x	9.0x	7.5x
Adecco	CHF	62.4	11679	18.7x	14.5x	10.0x	8.0x
<b>Average</b>				<b>16.0x</b>	<b>13.9x</b>	<b>8.9x</b>	<b>7.7x</b>
SGS's premium/discount				19.3%	18.2%	18.0%	14.5%
SGS's premium/discount vs. Intertek				5.8%	4.4%	-0.2%	-3.1%

Source: NZB Neue Zürcher Bank estimates, IBES/Multex estimates

Based on our upgraded estimates, we have now derived a new 'fair value NZB', based on EVA@/DCF models, of CHF 1046 per share (vs. CHF 1013, no deduction for insufficient soft factors), which leaves an upside of 13% for the stock.

- Opinion and recommendation:** Even if neither acquisitions nor financial targets have been announced, we think that our investment case is intact, and that SGS's growth story is advancing at full steam.

In addition, we came out of our first contact with the new CEO with a good feeling. His approach seems to be very structured as well as

focused on SGS' growth and future new business opportunities. We were impressed by the detailed information he has been able to gather in such a short period of time. We think that after a thorough review of the company, the new CEO could come up with ambitious, new targets for the company. His view on SGS expanding its services portfolio goes in that direction and is a hint of how he could combine the development of existing business and the development of new services, together with external growth. Given SGS present sound business and financial situation, Dan Kerpelman has inherited a jewel made out of rough diamonds of different quality. His job is now to bring all divisions or diamonds up to the same standard of quality, and to successfully add some new pieces to the jewel he has inherited. Given the above, and considering our estimates upgrades, we still consider the stock to be an attractive option. Moreover, as we described above in our three different scenarios, the expected acquisitions would generate additional shareholder value in future. This is a good reason to believe that SGS will very soon make use of its cash firepower, which would be the next trigger for the stock.

We believe that the downside risks (caused by external factors such as a dramatically weaker USD, a sharp slowdown in global trade or a valuation contraction) are limited, given the strong current momentum in the sector as well as the sound financial situation of the company.

Considering the stock's attractive upside potential to our new fair value of CHF 1046 per share, we have set a new price target at CHF 1040 (12% upside potential). We are sticking to our BUY rating on the SGS stock.

▪ **Agenda:**

- October/November 2005      Investor Day
- 17 January, 2006              Announcement of FY 2005 results

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