

Downgrading rating on insufficient upside from current levels

■ 2006 Results in-line with expectations

Sales came in at CHF3,821m (UBSe CHF3,831m, Consensus CHF3,820m), operating profit of CHF605m (UBSe CHF606m, Consensus CHF613m) and EPS of CHF56.4 (UBSe CHF57.2, Consensus CHF58.1). Top-line organic growth was 10.3% (UBSe 11.4%) with margin enhancement of 0.6% was in line with UBSe.

■ Growth in nine of ten divisions....

SGS showed positive organic growth in all divisions except Trade Assurance Services (Suffered from the loss of material contracts in 05). The star performers continued to be the consumer testing (21.7% organic growth), mineral services (15.9% organic growth), systems and services (14.7% organic growth) and Oil, Gas and Chemicals (13.2% organic growth) divisions.

■ New CEO, Chris Kirk comes across well.....

Our overall impression of the new CEO is favourable. Mr Kirk stressed diversification with the possibility that SGS would be willing to add on two new divisions (no mention of focus, although marine a strong possibility). Furthermore, cost reductions would remain a focus.

■ Valuation: PT of CHF1470 with Buy1 rating changed to Neutral1

We downgrade our rating of SGS from B1 to N1 on the back of insufficient upside to our PT, which we maintain. We value SGS on a DCF basis which provides a CHF1470 price target. At our PT SGS would trade at 22.3x UBS 2007E forecast EPS. Our DCF doesn't factor in any acquisitions.

Highlights (CHFm)	12/04	12/05	12/06E	12/07E	12/08E
Revenues	2,885	3,308	3,831	4,219	4,611
EBIT (UBS)	391	502	606	697	769
Net income (UBS)	289	371	430	502	555
EPS (UBS, CHF)	38.59	49.46	57.26	66.82	73.90
Net DPS (UBS, CHF)	12.00	50.00	18.00	20.00	22.00

Profitability & Valuation	5-yr hist. av.	12/05	12/06E	12/07E	12/08E
EBIT margin %	9.5	15.2	15.8	16.5	16.7
ROIC (EBIT) %	51.4	71.6	71.9	78.5	83.2
EV/EBITDA x	10.5	10.9	14.0	11.9	10.5
PE (UBS) x	17.3	18.7	24.4	20.9	18.9
Net dividend yield %	1.5	5.4	1.3	1.4	1.6

Source: Company accounts, Thomson Financial, UBS estimates. (UBS) valuations are stated before goodwill, exceptionals and other special items. Valuations: based on an average share price that year, (E): based on a share price of CHF1,395.00 on 12 Jan 2007 23:39 GMT

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Rating **Neutral 1**
Prior: Buy 1

Price target CHF1,470.00/US\$11.78
Unchanged

Price CHF1,395.00/US\$11.18 (ADR)

RIC: SGSN.VX BBG: SGSN VX

16 January 2007

Trading data (local/US\$)

52-wk. range	CHF1,399.00-1,057.00/US\$11.59-8.58
Market cap.	CHF10.9bn/US\$8.74bn
Shares o/s	7.8m (REG)/782m (ADR)
ADR ratio	100 ADR :1 REG
Free float	64%
Avg. daily volume ('000)	34/OTC
Avg. daily value (CHFm)	44.7

Balance sheet data 12/06E

Shareholders' equity	CHF1.44bn
P/BV (UBS)	7.6x
Net cash (debt)	CHF0.44bn

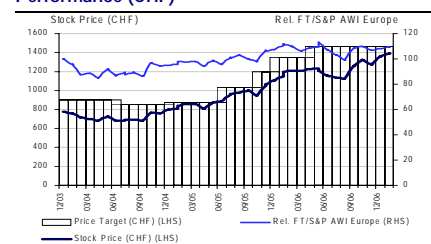
Forecast returns

Forecast price appreciation	+5.4%
Forecast dividend yield	1.3%
Forecast stock return	+6.7%
Market return assumption	7.4%
Forecast excess return	-0.7%

EPS (UBS, CHF)

	12/06E		12/05	12/08E
	From	To	Cons.	Actual
H1E	-	25.85	-	23.46
H2E	-	31.41	-	26.00
12/06E	-	57.26	58.15	
12/07E	-	66.82	66.70	

Performance (CHF)



Source: UBS

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Review of 2006 results

Results were in line to slightly below expectations. Sales came in at CHF 3,821m (UBSe CHF 3,831m, consensus CHF 3,820m), operating profit at CHF605m (UBSe CHF606m, Consensus CHF613m) and EPS of CHF56.4 (UBSe CHF57.2, Consensus CHF58.1). Top line organic growth was 10.3% (UBSe 11.4%) with the margin of 15.8% in line with the UBS forecast. We present some of the highlights below.

Top-line organic growth of 10.3% with broadly in-line results

Table 1: Group performance 2006E vs 2006A (CHFm unless stated)

	2005	2006 Forecast	2006 Actual	% change
Sales	3,308	3,831	3,821	-0.3%
Ebita	502	606	605	-0.2%
Profit before tax	507	626	623	-0.5%
Taxation	-119	-150	-155	3%
Profit after taxation	388	476	468	-1.7%
EPS - pre excep (CHF)	48.9	57.2	56.4	-1.4%

Source: UBS estimates and Company

The strongest organic growth came from those businesses which performed strongly during the first half of 2006.

- (1) **Consumer Testing Services – 21.7% organic growth vs our estimated 28%.** The company continues to benefit from the new RoHS legislation although demand moderated during the second half of the year resulting in SGS' second half organic growth being lower than forecast. However, we expect new legislation such as REACH should be supportive for this division in 2007. Whilst we are concerned that a slow down in world trade might impact the division in 2007, SGS has not seen any indications of a downturn. Furthermore, as long as the trend for increased product diversification continues we continue to feel our forecasts are well underpinned.
- (2) **Minerals Services – 15.9% organic growth vs our estimated c19%.** Growth has been driven by the increased trend for mineral companies to outsource their testing requirements, high and volatile commodity prices, and new product offerings by SGS. The company stresses that trading conditions remain favourable with those geographic areas with material mineral deposits benefiting the most. However, we do note that commodity prices have fallen during the start of the year and this may impact 2007E forecasts. Nevertheless, for the time we are not adjusting our forecasts as generally commodity prices impact mainly exploration activity (a small part of total activity for SGS) whilst other activities are more dependent on volatility levels that currently remain high.
- (3) **Systems and Services – 14.7% organic growth was slightly below our forecast 16.7%,** although SGS continuing to benefit from traditional compliance schemes.

- (4) **Oil, Gas and Chemical Services – 13.2% organic growth vs 14% forecast growth.** Growth was in-line with expectations partly driven by prior period investment in new laboratories and an ever increasing geographic footprint.
- (5) Decent levels of organic growth were achieved from **the Industrial Services division (13.1% organic growth vs. 12% estimate)** partly due to emerging market expansion plans, and continued growth in Western Europe.
- (6) The **Agricultural Services** delivered organic growth of 5.7% vs 9.3% forecast organic growth. The company attributes disappointing performance to “unsteady markets” in worldwide agricultural trade which has seen increased volatility in harvest conditions and commodity prices from the prior year. Furthermore, volumes in Central and Western Europe experienced reduced growth rates during the second half attributed to demand within the region being evenly balanced.
- (7) The main area of top-line weakness as expected was from the **Trade Assurance Services** division although with organic growth at -26.1% this is slightly better than the thirty percent expected decline. Negative growth has been driven by the loss of pre-inspection contracts in Venezuela and Nigeria, although the group continues to develop the service offering to make up for lost revenues.
- (8) The **Environmental Services division** performed slightly worse than expected (6.5% organic growth vs. 7.0% expected) following difficult trading conditions experienced during the first half of the year. Nevertheless, second half performance was supported by activity in the mining, construction and infrastructure industries.
- (9) Overall performance in the **Life Science and Automotive divisions** came in as expected, although the split between acquisition led and organic growth was not as expected (see below). In particular the **automotive division** experienced better than expected organic growth (4% vs. 3% expected) boosted by higher than expected volumes from statutory inspection activities.

We present a detailed summary of top-line performance in the below tables.

Table 2: Divisional sales 2006E vs – 2006A (CHFm)

	2005A	2006E	2006A	% Change Act vs Est.
Agricultural Services	295	326	317	-2.8%
Minerals Services	394	484	467	-3.5%
Oil, Gas & Chemical Services	636	766	783	2.3%
Life Sciences Services	125	193	193	0.2%
Consumer Testing Services	476	620	593	-4.4%
Systems & Services Certification	274	321	319	-0.7%
Industrial Services	445	504	510	1.3%
Environmental Services	235	235	249	6.0%
Automotive Services	200	221	220	-0.3%
Trade Assurance Services	229	163	169.0	3.7%
Total Sales	3,308	3,831	3,821	-0.3%

Source: UBS estimates and company

Table 3: Divisional Sales growth 2006E – 2006A (%)

	2005A	Total 2006E	Total 2006A	2006E organic	2006A organic
Agricultural Services	14.7%	10.4%	7.5%	9.3%	5.7%
Minerals Services	23.2%	23.0%	21.1%	19%	15.9%
Oil, Gas & Chemical Services	10.6%	20.5%	21.8%	14%	13.2%
Life Sciences Services	17.7%	53.7%	54.3%	0.3%	9.2%
Consumer Testing Services	32.1%	30.1%	24.5%	28%	21.7%
Systems & Services Certification	16.4%	17.1%	16.3%	16%	14.7%
Industrial Services	17.1%	13.2%	14.7%	12%	13.1%
Environmental Services	12.7%	0.1%	6.0%	7%	6.5%
Automotive Services	6.7%	10.4%	10.0%	3%	4.0%
Trade Assurance Services	-10.5%	-28.9%	-26.1%	-30%	-26.1%
Total Sales Growth	14.7%	15.8%	15.5%	11.0%	10.3%

Source: UBS estimates and company

Despite the margin being negatively impacted by the acquisition of businesses with lower than average group margins, the overall margin progression was as expected with a full year group margin of 15.8%. Unexpectedly margins in the **Systems and Industrial divisions** were higher benefiting from operating leverage and favourable service and geographic mix. Furthermore, the **Systems division** benefited from reduced back office costs. The **Trade Assurance division** delivered lower margins (13.7% vs. 16.5% UBSe) than forecast due to the impact of discontinued contracts and start up costs being greater than expected. However, given the margin enhancement incurred during 2006e (Margin enhancement in 7 of the 10 business divisions) we feel our forecast 16.5% margin for 2007E is well underpinned.

Group margin of 15.8% in-line with expectations

Table 4: Operating mix 2006E – 2006A (CHFm)

	2005A	2006E	2006A	% Act vs. Est	2006 vs 2005
Agricultural Services	33.5	40.5	39.4	-2.7%	17.6%
Minerals Services	63.1	84.0	80.5	-4.2%	27.6%
Oil, Gas & Chemical Services	79.4	109.0	112.6	3.3%	41.8%
Life Sciences Services	19.1	25.6	24.6	-3.9%	28.8%
Consumer Testing Services	102.1	142.5	136.8	-4%	34.0%
Systems & Services Certification	46.5	56.3	58.9	4.6%	26.7%
Industrial Services	58.6	68.2	74.7	9.5%	27.5%
Environmental Services	26.0	23.5	24.1	2.6%	-7.3%
Automotive Services	25.2	29.5	29.8	1%	18.3%
Trade Assurance Services	48.5	26.9	23.2	-13.7%	-52.2%
Total Ebita	502	606	605	-0.2%	20.5%

Source: UBS estimates and company

Table 5: Operating margins 2005A -2007E (%)

	2005A	2006E	2006A
Agricultural Services	11.4%	12.4%	12.4%
Minerals Services	16.0%	17.3%	17.2%
Oil, Gas & Chemical Services	12.5%	14.2%	14.4%
Life Sciences	15.2%	13.3%	12.7%
Consumer Services	21.4%	23.0%	23.1%
Systems & Services Certification	17.0%	17.5%	18.5%
Industrial	13.2%	13.5%	14.6%
Environmental Services	11.1%	10.0%	9.7%
Automotive	12.6%	13.3%	13.5%
Trade Assurance Services	21.2%	16.5%	13.7%
Total EBIT-margin (1)	15.2%	15.8%	15.8%

Source: UBS and company. (1) After corporate costs

Based on in-line results we see no reason to currently adjust our forecasts.

Other issues

Mergers and Acquisitions: There has been a degree of confusion in the market as to what the situation with Bureau Veritas and SGS's intentions regarding the company are in the short-term (Although Bureau Veritas and its parent company Wendel have both denied takeover talks with SGS). Nevertheless, SGS is looking to expand the pace of acquisition activity. For this reason the corporate development team intends to work closer and be involved at an earlier stage with the business units once acquisitions are identified.

Acquisition activity expected to accelerate

Capex and working capital: The group is guiding for capital expenditure of 5-7 percent of sales, although expectations will in all likelihood fall at the top end. The reason for top end capex expectations is partly due to meet the firms growth objectives (65 percent of capex relates to growth) but also due to the businesses

Capex expected to rise to top-end of guidance but working capital under control

SGS operates in becoming more capital intensive. However, working capital looks to be improving with DSO dropping by 2 days during 2006

Emerging market comments made at analyst presentation: The overall impression is that SGS is not opportunity constrained in Asia, East Europe nor the Middle East. Rather, the challenge is partly finding skilled resource to execute the opportunity without compromising service levels.

New CEO: On 29th November Dan Kerpelman resigned as CEO of SGS with Chris Kirk (Head of Minerals and Environmental Services) becoming the new CEO of SGS. Yesterday Chris spoke to the market, with our overall impression being favourable. Chris said that since he has joined management has reconfirmed the strategy and business dynamic. However, the new CEO is of the opinion that greater business diversity will be beneficial and potentially expand the number of divisions from 10 to 12 (organically and or through acquisitions). For instance, the company has no marine capacity which could be an obvious area for expansion. Nevertheless, the company is also committed to launching new products and services. In addition the CEO is looking to make further cost savings and coupled with favourable pricing margin risk remains on the upside.

Valuation

We continue to value SGS on a DCF basis and maintain our CHF1470 price target. However, it is worth noting that neither our forecasts, DCF valuation or price target incorporate anticipated bolt-on or strategic acquisitions. (Indeed our 2008E EPS forecast of CHF73 is materially lower than the company's targeted 2008 CHF80 EPS). On our CHF1470 price target SGS would trade at 22.3x forecast 2007 EPS. However, due to insufficient upside relative to our price target we downgrade SGS from Buy 1 to Neutral 1.

Ample market opportunities from emerging markets

New CEO comes off in a favourable light and is beginning to focus on further growth opportunities

CHF1470 price target maintained but rating downgraded from Buy 1 to Neutral 1

■ **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, loss of reputation, and a lack of or unfavourable regulation.

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UBS rating	Definition	UBS rating	Definition	Rating category	Coverage ¹	IB services ²
Buy 1	FSR is > 6% above the MRA, higher degree of predictability	Buy 2	FSR is > 6% above the MRA, lower degree of predictability	Buy	44%	36%
Neutral 1	FSR is between -6% and 6% of the MRA, higher degree of predictability	Neutral 2	FSR is between -6% and 6% of the MRA, lower degree of predictability	Hold/Neutral	43%	36%
Reduce 1	FSR is > 6% below the MRA, higher degree of predictability	Reduce 2	FSR is > 6% below the MRA, lower degree of predictability	Sell	13%	26%

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. Ratings allocations are as of 31 December 2006.

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% (a proxy for, and not a forecast 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.

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Companies mentioned

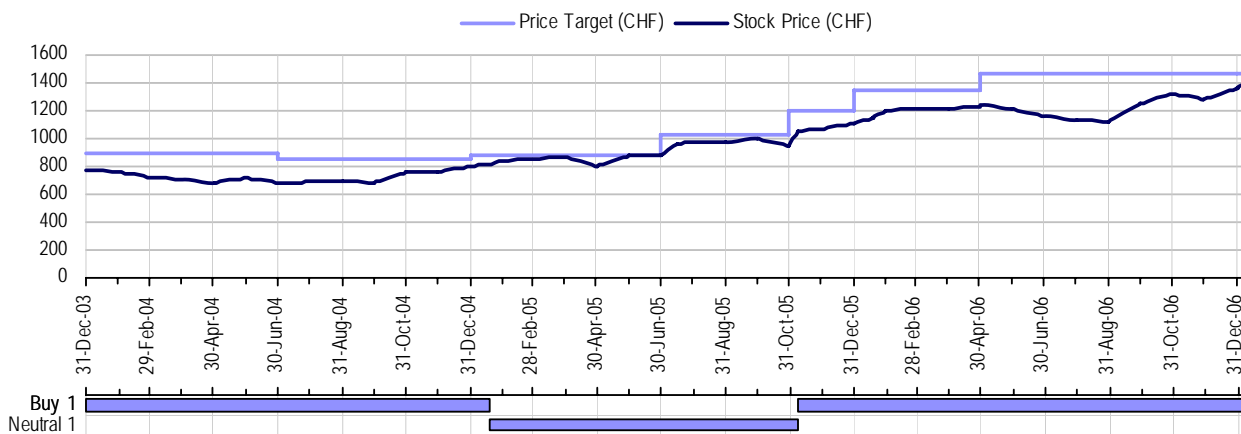
Company Name	Reuters	Rating	Price	Price date/time
SGS ^{4,5,13}	SGSN.VX	Neutral 1	CHF1,395.00	12 Jan 2007 23:39 GMT

Source: UBS. GMT: Greenwich mean time.

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

SGS (CHF)



Source: UBS; as of 12 January 2007.

Note: On September 9, 2006, UBS adopted new percentage band criteria for its rating system. (See 'UBS Investment Research: Global Equity Ratings Definitions and Allocations' table for details). Between October 13, 2003 and September 9, 2006 the percentage band criteria used in the rating system was 10%. Prior to October 13, 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. Excess return is defined as the difference between the FSR and the one-year local market interest rate.

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