

19th July 2016

Business Services

SGS SA

Price CHF2,204

Feedback conf. call and contact: Operating margin temporarily impacted. FV lowered.

Fair Value CHF2,360 vs. CHF2,400 (+7%)

BUY

Bloomberg	SGS VX
Reuters	SGS.VX
12-month High / Low (CHF)	2,314 / 1,626
Market Cap (CHFm)	17,240
Ev (BG Estimates) (CHFm)	17,777
Avg. 6m daily volume (000)	22.40
3y EPS CAGR	7.2%

Despite H1 strong organic revenue growth up 3.4%, adjusted operating result was broadly flat vs. last year representing an adjusted operating margin of 14.2% down 60bps vs stability anticipated. This is mainly due to three factors and if management is not worried about its mid-term objectives, the delay cannot be filled in the short term and we have to reduce our expectation. Actually, after limited adjustment on top line, we now anticipate adjusted operating margin down 40bps vs. last year's 15.6%. Based on our new estimates, our FV moves to CHF2,360 from CHF2,400.

	1 M	3 M	6 M	31/12/15
Absolute perf.	6.5%	4.9%	23.1%	15.3%
Inds Gds & Svs	2.9%	-0.6%	9.7%	-1.7%
DJ Stoxx 600	4.0%	-1.6%	3.1%	-7.4%

ANALYSIS

- **Three main factors explain the H1 margin decrease of 60bps:** First of all, as expected and guided by the management, adjusted operating margin was impacted by recent acquisitions (impact of 25bps) and notably Accutest Laboratories in USA in January in environmental service testing. Secondly and not anticipated incremental spending mainly IT to improve efficiency (20bps) while measures taken last year haven't yet delivered results and finally again some negative impact (15bps) from OGC and Minerals with a recovery that is slow to materialize.
- **H2 margin under pressure even if in a lesser extent compared to H1:** The gap will be gradually closed in H2, but not totally. In fact, acquisitions will continue to weigh on margin at least 12 months more and full benefit from cost savings notably on procurement is anticipating next year. All in all, for FY 2016, management confirmed its organic growth guidance of between 2.5% and 3.5% (which implies lower growth in H2 vs. H1 taking into account challenging trading conditions which persist in energy and mining industries), with an increase in adjusted operating results (our estimate is CHF949m vs. CHF917 last year implying a margin down 40bps).

YEnd Dec. (CHFm)	2015	2016e	2017e	2018e
Sales	5,712	6,082	6,351	6,669
% change		6.5%	4.4%	5.0%
EBITDA	1,144	1,254	1,327	1,411
EBIT	916.9	948.6	1,013	1,079
% change		3.5%	6.8%	6.5%
Net income	625.4	651.2	700.9	748.2
% change		4.1%	7.6%	6.8%

Main adjustments on our estimates

	2015	2016e	2017e	2018e
Operating margin	16.1	15.6	16.0	16.2
Net margin	10.9	10.7	11.0	11.2
ROE	32.8	33.6	34.8	35.6
ROCE	20.9	20.7	21.5	22.0
Gearing	24.2	26.6	25.1	23.5

	2016e			2017e			2018e		
	Old	New	Change %	Old	New	Change %	Old	New	Change %
SALES	6 125	6 082	-0,7%	6 395	6 351	-0,7%	6 715	6 669	-0,7%
EBITDA	1 292	1 254	-2,9%	1 353	1 327	-1,9%	1 434	1 411	-1,6%
	21,1%	20,6%	-47 bp	21,2%	20,9%	-25 bp	21,3%	21,1%	-20 bp
EBIT	984	949	-3,6%	1 036	1 013	-2,2%	1 099	1 079	-1,9%
	16,1%	15,6%	-47 bp	16,2%	16,0%	-25 bp	16,4%	16,2%	-20 bp
EPS	89,19	85,86	-3,7%	96,91	94,57	-2,4%	103,09	100,96	-2,1%

Source : Company Data; Bryan Garnier & Co. ests.

- **Nevertheless, management remains confident about its medium-term targets (2016-2020):** Despite that gap on adjusted operating margin which should take some time to be totally filled, management remains committed and confident to delivering on its medium numbers with notably mid-single-digit organic growth on average, contribution from acquisitions to revenue of EUR1bn during the period and adjusted operating margin of at least 18%.

VALUATION

- Based on average valuation between a DCF and the 10-year historical EV/EBIT multiple used as the exit multiple FY+3, our FV move to CHF2,360. Note that our estimates are based on lower numbers than guided by the management notably on adjusted operating margin using a long-term target of 17%.
- At the current share price, the stock is trading at 18.7x EV/EBIT and 17.5x 2017e which compares with a median historic multiple of 14.8x and CAGR 2015-2018 of 5.6%.

NEXT CATALYSTS

- Capital market days on 27th & 28th October (Krokow-Poland)



Analyst :

Bruno de La Rochebrochard

33(0) 1 56 68 75 88

bdelarochebrochard@bryangarnier.com

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London	Paris	New York	Munich	New Delhi
Beaufort House	26 Avenue des Champs Elysées	750 Lexington Avenue	Widenmayerstrasse 29	The Imperial Hotel Janpath
15 St. Botolph Street	75008 Paris	New York, NY 10022	80538 Munich	New Delhi 110 001
London EC3A 7BB	Tel: +33 (0) 1 56 68 75 00	Tel: +1 (0) 212 337 7000	Germany	Tel +91 11 4132 6062
Tel: +44 (0) 207 332 2500	Fax: +33 (0) 1 56 68 75 01	Fax: +1 (0) 212 337 7002	+49 89 2422 62 11	+91 98 1111 5119
Fax: +44 (0) 207 332 2559	Regulated by the	FINRA and SIPC member		Fax +91 11 2621 9062
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Financial Conduct Authority (FCA)	Autorité de Contrôle prudentiel et de			rue de Grenus 7
	resolution (ACPR)			CP 2113
				Genève 1, CH 1211
				Tel +4122 731 3263
				Fax+4122731 3243
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