

4 September 2008

SQS Software Quality Systems AG

| Year End | Revenue (€m) | PBT* (€m) | EPS* ** (p) | DPS (p) | PE (x) | Yield (%) |
|----------|--------------|-----------|-------------|---------|--------|-----------|
| 12/06 | 78.9 | 5.3 | 22.7 | 0.0 | 13.4 | N/A |
| 12/07 | 121.1 | 10.5 | 33.7 | 15.9 | 9.0 | 5.2 |
| 12/08e | 146.9 | 13.4 | 33.7 | 9.6 | 9.0 | 3.2 |
| 12/09e | 163.2 | 15.7 | 34.2 | 10.4 | 8.9 | 3.4 |

Note: *PBT and EPS are normalised, excluding goodwill amortisation and exceptional items.

** Historic EPS are adjusted to reflect actual tax and interest rates rather than reported and an exchange rate £0.81/euro as at 2 September 2008.

Investment summary: A results business

Quite simply another set of excellent results from the global market leader in independent software testing. Turnover and EPS both increased by over 20% and once again we have moved ahead our estimates. SQS has a solid business case, a proven management team and an undemanding valuation. Secular growth potential in its core activity helps assuage concerns over the macro climate.

Interim results

Top line growth of 23%, together with a 1.5 percentage point rise in operating margins to 9.8%, delivered a 21% rise in EPS. All the major geographic territories performed well but the largest market, Germany, was the star turn with organic growth of 30%. The translational impact of a strong euro held back progress elsewhere, but overall these were another excellent set of figures.

Outlook and forecasts

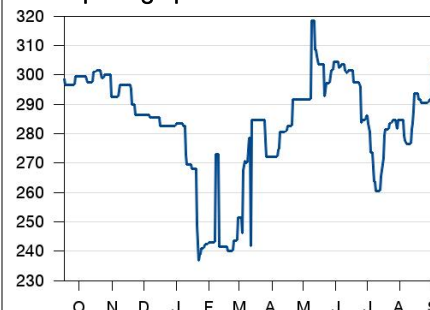
Investors are right to be concerned about the potential for a slowdown in expenditure on major IT projects in the current economic climate. However, growth at SQS is so far ahead of this market because whatever the backdrop, independent testing is a market that will fare relatively well given the failure rate of software implementation and the fact that still around 90% of testing is conducted in-house. With the benefit of recent acquisitions to further boost growth and diversify the geography, and given the strong organic backdrop, we have again raised turnover and PBT estimates by broadly 5% in this year and next.

Valuation and conclusion

Three factors make for a compelling investment case for SQS: 1) the strength of the business case; 2) the quality of earnings (ie recurring and long-term contracts) and; 3) an attractive valuation on an earnings, comparative and DCF basis. For a growth stock, even the yield is appealing, and despite the steadfastness of the share price in a volatile equity market environment, we remain confident of the prospect for further outperformance.

Price 303.5p
Market Cap £69m

Share price graph



Share details

Code SQS
Listing AIM
Sector Software & IT Services
Shares in issue 22.82m

Price

52 week High 315.5p Low 236.5p

Balance Sheet as at 30 June 2008

Debt/Equity (%) 2.2
NAV per share (€) 2.16
Net debt (€m) 1.1

Business

SQS is the largest independent provider of software testing and quality management services. The majority of the group's revenues are derived from consultancy services to a client base including a long list of blue chip customers.

Valuation

| | 2007 | 2008e | 2009e |
|--------------|------|-------|-------|
| P/E Relative | 64% | 87% | 95% |
| P/CF | 5.3 | 6.6 | 5.4 |
| EV/Sales | 0.5 | 0.6 | 0.6 |
| ROE | 16% | 17% | 18% |

Geography based on revenues

| | Europe | US | Other |
|----|--------|----|-------|
| UK | 65% | 0% | 2% |

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Investment summary: A results business

Company description

SQS is the global leader in the provision of independent software testing and quality management. The vast majority of the group's revenues are derived from consultancy services to a client base that now includes almost 50% of the companies in the FTSE 100 and the DAX 30. SQS also generates revenues from its training and conference business and the development of specialised software tools. The company was founded 25 years ago in Germany by the current CEO and former COO, and although Germany remains the largest market, the UK has become increasingly important. There are operations in a number of other European markets as well as South Africa.

Valuation

The investment case for SQS is supported in the first instance by a high quality of earnings generated through recurring revenues and a growing proportion of long-term contracts. This is underpinned by an attractive valuation in virtually all respects and a management team that has never disappointed. With a sub 10x PE in each of the next two years, a growing and not insubstantial yield and a DCF analysis now suggesting intrinsic value significantly north of 400p, the shares continue to be one of *the* quality plays in the Software & IT Services sector.

Sensitivities

When assessing the potential factors which can impact the investment case, the following sensitivities should be considered:

- **Cyclicality:** Despite its advantages — and potentially positive impact on ROIs — external testing does represent an initial 'cost' and could therefore be vulnerable in a general economic downturn.
- **Financial services:** This sector represents c 30% of turnover, and recent industry turmoil may affect budgets for new software implementation and testing.
- **Acquisition risks:** The management's strategy is to continue to make in-fill acquisitions in a fragmented market, and although this does mean a heightened risk profile, the record so far is a strong one.
- **IT services market growth:** Growth in the testing market is linked to overall growth in the IT market, and any secular decline here would have a knock-on effect.
- **Offshoring:** Growth in this trend could present a threat, although the company's own South African operations — as well as the recent acquisition in India — enable SQS to offer a high-quality in-house alternative.

Financials

SQS is a strongly cash-generative business with a robust balance sheet and low capital requirements. Robust pricing power and high levels of utilisation for consultants have continued throughout H108, and the outlook for the remainder of the year is encouraging. We continue to see scope for further margin growth and strong cash generation.

Interim results 2008

Exhibit 1: Summary of interim results for the six months to 30 June 2008

| €m | 2008 | 2007 | % |
|---------------------------------|---------------------|---------------------|-----|
| | six mths to 30 June | six mths to 30 June | |
| Turnover | 68.9 | 56.2 | +23 |
| Gross margin (%) | 34.7% | 34.5% | |
| Operating profit | 6.8 | 4.7 | +43 |
| Profit/(loss) before tax (norm) | 6.7 | 4.6 | +45 |
| EPS normalised (c) | 0.23 | 0.21 | +21 |
| Cash inflow from op. activities | 4.2 | 3.8 | +11 |

Source: SQS

Financial review: Strong profitable growth

Once again, an excellent set of figures from SQS reveal significant organic growth and rising profitability. The 23% advance in turnover to €68.9m was overwhelmingly organic and continued the now well-established trend of significantly exceeding a rate of growth in the wider IT services market estimated by IDC to be c 5%. Margins also rose at all levels – from 8.4% to 9.8% at the operating level – reflecting a number of trends, but perhaps most significantly improved pricing power in the major markets and costs savings associated with rising economies of scale. Normalised EPS advanced by 21% to 23c and as discussed in the valuation section, this makes the current PE very appealing. Finally, these results were achieved despite an adverse currency impact due to 44% of group turnover being outside of the recently strong euro.

Operational review

SQS has built a proven track record based around delivering consistently excellent results; the 2008 interims are no exception. The principal features from an operating perspective remain the same and are based around the ability to drive new business wins and long-term contracts from a market leadership position in an industry exhibiting secular growth.

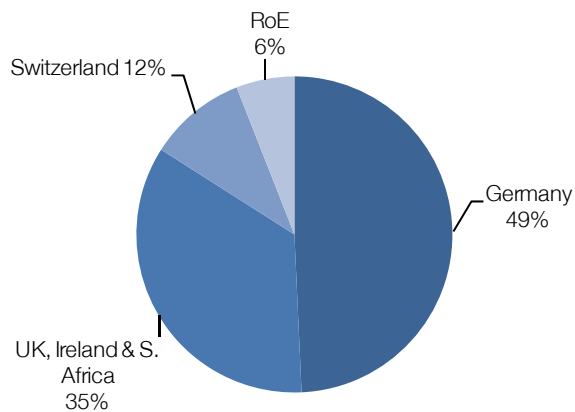
The arguments in favour of independent testing remain as compelling as ever and at their core reflect the need to improve the failure rates of software implementation. It still remains the case that around 90% of testing is carried out in-house and yet only about one-third of all IT projects are successfully implemented on time and within budget. In our view, these is also a counter-cyclical feature which should make SQS relatively immune to any overall downturn in IT expenditure, especially given its recurring revenues are now around the 80% mark.

Business wins recorded during H1 were impressive, with 78 clients signed up across 22 industries, compared to 64 new customers in H107. This continues the theme of diversifying the client base while at the same time still focusing on the 'blue chip' end of the market. A high quality of earnings is reflected in the fact that as described above, something like 80% of group sales represent 'recurring revenues'. However, the growing proportion of long-term contracts also reinforces this view and having increased from 8% of turnover to 11% in 2007, the trend has continued upwards in 2008. Finally, it is only through recruiting and training appropriate consultants that SQS can continue to fuel this growth, and during the first half of 2008, 134 new consultants were taken on to lift the overall number of employees to 1,151, compared to 860 at the halfway stage in 2007.

Geographic analysis

As Exhibit 2 below illustrates, Germany is the most significant contributor by geography, and during H1, it was also the star performer in terms of growth, seeing turnover rise 29.9% to €33.9m — all of which was organic. This reflects a number of major contract wins, strong demand and the pricing power that a market leadership position confers.

Exhibit 2: Geographic analysis H108



Source: Edison Investment Research

Good progress was also made – although on somewhat less dramatic fashion – in the UK, Ireland and South Africa, where revenues grew a more modest albeit healthy 6.4% to €23.9m. In part, this reflected the weakness of sterling against the euro – in constant currency terms, UK revenues would have been €2.8m higher – ie a growth rate for this region as a whole of 18.7%. Organic growth in Switzerland saw revenues advance 15.6% to €6.9m and the bulk of a 148% rise in sales in the rest of Europe was due to the successful integration of Triton acquired in August last year.

Recent acquisitions

The acquisition of Swedish-based Validate for €16.4m is consistent with the strategy of expanding the European footprint, while the much smaller purchase of Verisoft in India adds another dimension to the offshoring capability. Validate also operates in Finland and Norway and is an excellent complementary fit for SQS geographically. A customer base of 20 includes many of the region's 'blue chip' companies. Meanwhile, the acquisition of the Indian software-testing business Verisoft for a maximum of €1.8m increases the range of offshore options available for clients. Verisoft has carried out projects for some 100 customers, of which 50% are based outside India. Both deals are expected to be earnings enhancing and were completed just after the half year end.

Forecasts

The principal driver behind the latest upwards revision in forecasts is the performance of the German market. With the largest geographic territory having grown sales organically by a remarkable 29.9% in the first half, there is clearly a need to move up forecasts. The strength of pricing power in across all markets also means that we are able to edge margins ahead as well and through a combination of these factors, our numbers for 2008 and 2009 are being raised by broadly 5% across the board.

This is not to say that we do not remain mindful of a more uncertain macroeconomic backdrop – particularly in the UK. However, we believe this is already reflected in prudent estimates for 2009 when we are expecting turnover growth to moderate to 11% and group operating margins to be around the 9% mark.

Exhibit 3: Revision of forecasts

| €m | 2008 | | 2009 | |
|---------|---------------|--------------|---------------|--------------|
| | Previous est. | New forecast | Previous est. | New forecast |
| Revenue | 139.9 | 146.9 | 155.4 | 163.2 |
| PBT | 12.8 | 13.4 | 14.9 | 15.7 |
| EPS (c) | 39.7 | 41.5 | 42.0 | 42.2 |

Source: Edison Investment Research

Valuation and conclusion

When assessing the potential upside in the SQS share price, investors should also be mindful of the weight that has to be given to a management with a track-record of avoiding disappointment, and also to the high-quality nature of the earnings stream. When these are taken in the context of a PE comfortably below 10x and the substantial uplift implied by our DCF analysis, the arguments in favour of further outperformance remain strong.

Star attraction

A PE multiple of sub 10x is far from heady for a business growing at a multiple of the wider IT market place with scope for further increases in margins. As earnings unwind to reflect a more normalised tax charge, EPS growth flattens out in each of the next two years, but at the PBT level, we are expecting to see growth of 28% in FY08, followed by 17% in FY09. In our view, this helps underpin the PE multiple, especially when one considers the record of the company in matching and surpassing expectations.

The commencement of dividend payments from the 2007 financial year represents a further vote of confidence and is testament to the ability of the business to generate net cash. A yield of 3% — based on a pay-out policy roughly equivalent to 30% of earnings — has attractions in its own right, especially given the potential growth in the future.

Inherent value

Since we last published our DCF analysis in March, today's note represents our second upgrade to forecasts – the first being on the back of the two recent acquisitions, both of which are expected to be earnings-enhancing. Consequently, there has been a substantial shift up in our forecast DCF value, which, even based on conservative assumptions including a 15% WACC, suggests that a target price of well over 400p is not unrealistic.

Exhibit 4: DCF Valuation based on WACC of 15%

| | |
|--------------------------------|------|
| Discount Rate | 15% |
| NPV Forecast Period €m | 62.2 |
| Growth rate in perpetuity | 5% |
| NPV Terminal Value €m | 49.1 |
| Net cash 2007 €m | 6.9 |
| Equity Value per share (pence) | 444p |

Source: Edison Investment Research

Conclusion

In summary, SQS is a market-leading quality player in a growth industry with valuation dynamics that are not demanding, and we continue to see a healthy outlook as the company generates a broad spread of organic expansion across its major territories. Recent acquisitions are a complementary geographic fit and strategically, the small but significant step into India adds an important dimension to the ability to provide offshoring solutions in-house.

The secular growth potential in the market for independent software testing and quality management should enable the company to ride out a more challenging economic backdrop over the next two years, and our forecasts are in any event conservatively based. Management has developed an enviable record for delivery over the past three years, and given the strength of the business case and the undemanding valuation, we remain confident over future prospects.

Exhibit 5: Financials

| | €'000s | 2005 | 2006 | 2007 | 2008e | 2009e |
|---|--------|-----------------|-----------------|-----------------|-----------------|-----------------|
| Year end 31 December | | | | | | |
| PROFIT & LOSS | | | | | | |
| Revenue | | 54,737 | 78,933 | 121,059 | 146,900 | 163,200 |
| Cost of Sales | | (35,563) | (51,997) | (79,307) | (94,751) | (104,448) |
| Gross Profit | | 19,174 | 26,936 | 41,752 | 52,150 | 58,752 |
| EBITDA | | 6,847 | 8,506 | 14,124 | 16,923 | 19,221 |
| Operating Profit (before GW and except.) | | 4,486 | 5,734 | 10,513 | 13,312 | 15,610 |
| Goodwill Amortisation | | 0 | 0 | (241) | (740) | (740) |
| Exceptionals | | 0 | (276) | (561) | (500) | (250) |
| Other | | 0 | 0 | 0 | 0 | 0 |
| Operating Profit | | 4,486 | 5,458 | 9,711 | 12,072 | 14,620 |
| Net Interest | | (773) | (390) | (46) | 100 | 100 |
| Profit Before Tax (norm) | | 3,713 | 5,344 | 10,467 | 13,412 | 15,710 |
| Profit Before Tax (IFRS) | | 3,713 | 5,068 | 9,665 | 12,172 | 14,720 |
| Tax | | (1,319) | (383) | (2,932) | (3,889) | (4,556) |
| Profit After Tax (norm) | | 3,475 | 4,573 | 7,535 | 9,522 | 11,154 |
| Profit After Tax (IFRS) | | 2,394 | 4,685 | 6,733 | 8,282 | 10,164 |
| Average Number of Shares Outstanding (m) | | 11.7 | 16.5 | 19.1 | 22.9 | 26.5 |
| EPS - normalised (c) | | 20.5 | 27.8 | 41.5 | 41.5 | 42.2 |
| EPS - IFRS (c) | | 20.5 | 28.4 | 35.3 | 36.1 | 38.4 |
| Dividend per share (c) | | 0.0 | 0.0 | 20.0 | 12.0 | 13.0 |
| Gross Margin (%) | | 35.0% | 34.1% | 34.5% | 35.5% | 36.0% |
| EBITDA Margin (%) | | 12.5% | 10.8% | 11.7% | 11.5% | 11.8% |
| Operating Margin (before GW and except.) (%) | | 8.2% | 7.3% | 8.7% | 9.1% | 9.6% |
| BALANCE SHEET | | | | | | |
| Fixed Assets | | 16,747 | 36,033 | 56,598 | 65,126 | 65,126 |
| Intangible Assets | | 13,984 | 31,669 | 51,976 | 60,126 | 60,126 |
| Tangible Assets | | 2,763 | 4,364 | 4,622 | 5,000 | 5,000 |
| Investment in associates | | 0 | 0 | 0 | 0 | 0 |
| Current Assets | | 18,857 | 26,432 | 35,689 | 31,668 | 37,676 |
| Stocks | | 135 | 314 | 139 | 200 | 200 |
| Debtors | | 11,951 | 23,289 | 28,173 | 30,000 | 31,000 |
| Cash | | 6,465 | 2,565 | 7,220 | 1,018 | 5,976 |
| Current Liabilities | | (13,123) | (27,530) | (33,930) | (31,700) | (31,700) |
| Creditors & other liabilities | | (9,347) | (22,200) | (33,739) | (31,500) | (31,500) |
| Short term borrowings | | (3,776) | (5,330) | (191) | (200) | (200) |
| Long Term Liabilities | | (4,286) | (8,436) | (9,339) | (9,000) | (9,000) |
| Long term borrowings | | (2,971) | (465) | (105) | 0 | 0 |
| Other long term liabilities | | (1,315) | (7,971) | (9,234) | (9,000) | (9,000) |
| Net Assets | | 18,195 | 26,499 | 49,018 | 56,094 | 62,102 |
| CASH FLOW | | | | | | |
| Operating Cash Flow | | 4,106 | 2,909 | 13,291 | 12,796 | 18,221 |
| Net Interest* | | (833) | (492) | (497) | 100 | 100 |
| Tax | | (509) | (841) | (1,440) | (2,932) | (3,889) |
| Capex | | (2,961) | (3,199) | (2,930) | (4,000) | (4,000) |
| Acquisitions/disposals | | 95 | (4,080) | (3,578) | (7,870) | (2,720) |
| Financing | | 14,120 | 2,755 | 5,308 | 0 | 0 |
| Dividends | | 0 | 0 | 0 | (4,200) | (2,754) |
| Net Cash Flow | | 14,018 | (2,948) | 10,154 | (6,107) | 4,958 |
| Opening net debt/(cash) | | 14,300 | 282 | 3,230 | (6,924) | (818) |
| HP finance leases initiated | | 0 | 0 | 0 | 0 | 0 |
| Other | | 0 | 0 | 0 | 0 | 0 |
| Closing net debt/(cash) | | 282 | 3,230 | (6,924) | (818) | (5,776) |

Source: Company accounts/Edison Investment Research

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