Review

Edison investment research

6 September 2007

SQS Software Quality Systems AG

Year end	Revenue (€m)	PBT* (€m)	EPS* ** (p)	DPS (p)	PE (x)	Yield (%)
12/05	54.7	3.7	14.9	0.0	17.3	N/A
12/06	78.9	5.3	18.9	0.0	13.7	N/A
12/07e	112.7	8.6	22.7	10.4	11.4	4.0
12/08e	123.8	11.0	23.9	6.0	10.8	2.3

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 £1: 0.676 Euros as at 5 September 2007.

Investment summary: Go organic

Interim results confirm an acceleration in organic growth to 25% for the half year along with rising margins and a healthy net inflow of cash. SQS is delivering the kind of operating performance which should warrant a higher rating. With a P/E of just 11.4x and a DCF of at least 325p, there is plenty of room for further upside.

Interim results and new forecasts

The first time impact of the Cresta acquisition is a big driver behind a 79% growth in the top line and a virtual doubling of gross profit in H1. Nonetheless, the underlying picture is overwhelmingly positive — organic growth of 20% in Q1 has accelerated to 25% for the half year as a whole. With improved margins and increased pricing power, SQS is firmly on track to exceed market expectations for the full year. Accordingly, we have raised our forecasts for PTP in 2007 to €8.6m (up 9% from the previous estimate) and €11.0m in FY08 (+6%). EPS estimates have also risen by 10% and 12% respectively — positively impacted by a lower rise in the FY08 tax charge.

Acquisition of Triton

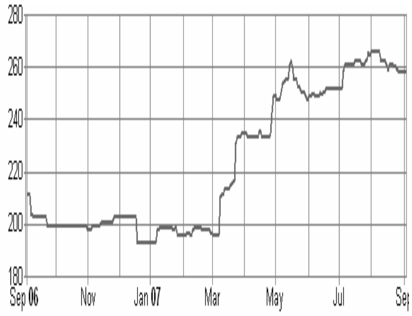
The recently acquired Triton specialises in consultancy services to the insurance industry with clients in Germany, Austria and Switzerland. In essence, the acquisition essentially meets two strategic aims. Firstly, it augments the Management Consulting practice established in 2006 by SQS and secondly, Triton provides SQS with opportunities to cross sell the services of its core software testing business. The maximum consideration payable is €15.5m over the next two years and the deal is expected to be immediately earnings enhancing as reflected in our revised forecasts.

Outlook and valuation

Since we initiated on SQS in March the shares have risen by approximately 30%. Nonetheless, the valuation is still not demanding and the momentum in organic growth continues to build. The market for independent software testing is both fragmented and growing and as the leading player, SQS is well placed to take advantage. The P/E and DCF valuations are undoubtedly attractive as is the prospect of an enhanced maiden dividend. If organic growth continues at these rates, forecasts will inevitably have to rise again.

Price	258p
Market Cap	£48m

Share price graph



Share details

Code	SQS
Listing	AIM
Sector	Software & IT Services
Shares in issue	18.7m

Price

	High	Low
52 week	266p	191.5p

Balance Sheet as 31 Dec 2006

Debt/Equity (%)	12.2
NAV per share (€)	160.8
Net borrowings (€m)	3.2

Business

SQS is Europe's largest provider of independent software testing and quality management. 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

	2006	2007e	2008e
P/E Relative	90%	75%	67%
P/CF	7.3	14.6	5.4
EV/Sales	0.6	0.6	0.5
ROE	13%	17%	16%

Geography based on revenues FY06

UK	Europe	US	Other
30%	70%	0%	0%

Analyst
Jason Holden 020 7190 1755
jholden@edisoninvestmentresearch.co.uk
Andrew Bryant 020 7190 1755
abryant@edisoninvestmentresearch.co.uk

SQS Software Quality Systems AG is a research client of Edison Investment Research Limited

Independent software testing

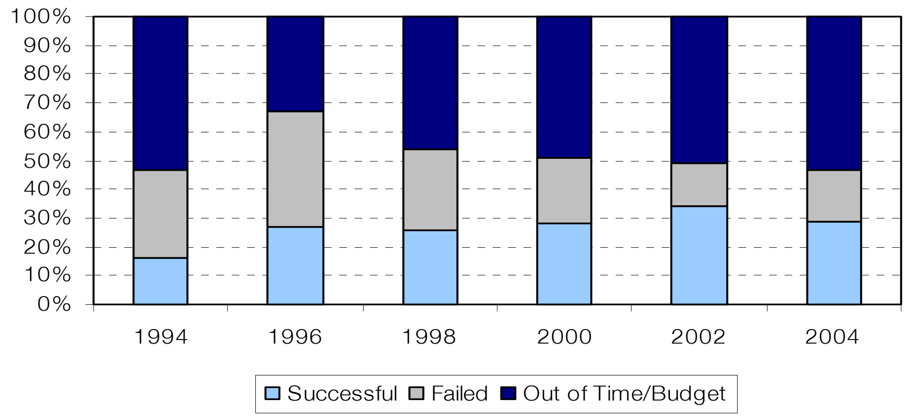
Core activities

SQS is Europe's largest provider of independent software testing and quality management. The majority of the group's revenues are derived from consultancy services to a client base including a long list of blue-chip customers. SQS also generates revenues from its training and conference business and the development of specialised software tools. Germany is still the largest market, but the UK has become increasingly important and Switzerland is also a key territory. There are operations in a number of other European markets, as well as South Africa.

The market for software testing and quality management

The fundamental driver behind the demand for independent software testing and quality management is the dismal failure rate of IT projects. The Standish Group — a US based organisation dedicated to assessing risk, cost, return and value in IT — surveyed a wide variety of projects between 1994 and 2004. Its conclusion was that less than one third of such undertakings are successful — i.e. 71% of global IT projects either fail or fall behind time and budget.

Exhibit 1: IT projects: Success vs. failure



Source: SQS

Independent testing is still a small fraction of the overall market with approximately 85% of testing carried out in-house. Given the failure rates of projects described above, there is a strong case to be made that a 'second opinion' should be sought when corporates undertake major IT initiatives. The potential for growth in the SQS offering is therefore significant and organic growth at the company has historically outstripped the expansion in the total IT market.

Customer base

SQS had a total of approximately 400 clients at the end of 2006 and the blue chip nature of the customer base is unquestionable; 50% of DAX 30 and 30% of Eurostoxx 50 companies, as well as 5 of the top 10 largest companies in the FTSE-100. The group now has a firm base in two equally strong markets in Germany and the UK and an increasing presence in other territories. In H107, the company recorded 64 new client wins — c.15% of the total customer base — compared to 100 in the whole of 2006.

Interim results 2007

The interim results were significantly impacted by the consolidation of the Cresta acquisition which appears in the H1 figures for the first time and which added almost 54% (c.€17m) to the top line. Nonetheless, organic growth has accelerated from 20% in Q1 to 25% for the half year as a whole. This confirms the now well established trend of SQS delivering premium growth to the overall IT Services market which is expanding at a significantly more modest 5%.

Exhibit 2: Summary of interim results for the six months to 30 June 2007

€m	2006 six mths to 30 June	2007 six mths to 30 June	%
Turnover	31.5	56.2	+79
Gross margin (%)	32.3%	34.5%	
Operating profit	1.9	4.7	+147
Profit/(loss) before tax (norm)	1.7	4.6	+169
EPS (c)	0.1	0.19	+90
Cash/(net debt)	-6.1	3.5	N/A

Source: SQS

The key drivers to the underlying picture are the two main markets of Germany and the UK which both benefited from increased pricing power and consistently high levels of consultant utilisation. Consequently, group gross margins rose to 34.5% and the group generated a positive cash inflow of €3.8m compared with a small outflow in H106 helped by a fall in debtor days.

Staff numbers rose by 127 to 860 and the vast majority of the additions were consultants; this would normally result in a negative impact on margins, but pricing power was able to offset this. Across the main territories, organic growth was strongest in Germany (+29%), but the UK wasn't far behind at 25%; these two markets comprised 86% of total revenues.

Net cash at the half year-end was €3.5m which was slightly above the figure at the previous full year, although this will reduce significantly in H2 due to the acquisition of Triton. Overall, the results underpin an exciting rate of growth in the underlying business and, along with the expected earnings enhancement from Triton, means we are raising our forecasts as detailed in Exhibit 3.

Acquisition of Triton

Complementary business

Just prior to the announcement of the interim results, SQS acquired Triton, a private Austrian company specialising in consultancy services to the insurance industry with clients in Germany, Austria and Switzerland. In particular, Triton specialises in helping its customers improve the efficiency of processing in their back-office operations and is independent of software producers in this respect.

The acquisition essentially meets two strategic aims: 1. it augments the Management Consulting practice established in 2006 by SQS, and 2. Triton provides SQS with opportunities to cross sell the services of its core software testing business.

The initial consideration is €4.4m in cash and this could rise to a maximum of €15.5m over the next two years — with a 51:49 split of equity and cash — subject to criteria including profitability, revenue and new business wins. In the 12 months to 31 December 2006, Triton had sales of €4.8m and profit before tax of €1.1m and is expected to be immediately earnings enhancing.

In addition to the impact of Triton, the acceleration in organic growth and a slightly lower rise in the tax charge have also had a positive effect on our forecasts and we have revised numbers accordingly.

Exhibit 3: Revision of forecasts

€m	2007 Previous est.	2007 New forecast	2008 Previous est.	2008 New forecast
Revenue	104.5	112.7	115.0	123.8
PBT	7.9	8.6	10.1	11.0
EPS (c)	30.6	33.6	31.5	35.3

Source: Edison Investment Research

Valuation and conclusion

The interim results clearly confirm a very positive picture for a company enjoying a strong growth phase in its development. An acceleration of organic expansion to 5x the rate of the overall IT Services market is confirmation of the compelling proposition of independent software testing.

Although, the investment case at SQS is not without its risks — in previous notes we have highlighted the sensitivities to cyclicality, expansion by acquisition, trends in the overall IT market and off-shoring — the current outlook is fundamentally very positive. In addition, although margin pressures could have been expected given the hiring rate of consultants, pricing power has been firm enough to offset this.

In conclusion, SQS is a market leader in a growth field and the risks to forecasts are very much on the upside if organic growth continues at anything like current levels. Despite this, the valuation metrics are undemanding with a P/E of only a little over 10x in 2008, and perhaps the market will now start to look more confidently beyond the short-term negative impact on earnings growth of a higher tax charge and a rise in the number of shares due to earn-outs.

The payment of an enhanced maiden dividend in FY07 (reflecting the postponement due to technicalities of the 2006 payment) should open up the investment opportunity to a wider audience and inherently strong cash generation holds out the prospect of some meaningful yield support. Finally, the higher base established by new forecasts means we have raised our DCF base case to 325p although if organic growth continues at similar levels, we see every opportunity to move this target higher.

Exhibit 4: DCF Valuation based on WACC of 15%

Discount Rate	15%
NPV Forecast Period €m	42.9
Growth rate in perpetuity	5%
NPV Terminal Value €m	39.7
Net debt 2006 €m	3.2
Equity Value per share (pence)	325p

Source: Edison Investment Research

This page is intentionally left blank

This page is intentionally left blank

Exhibit 5: Financials

Year-end 31st December	€'000s 2005	2006	2007e	2008e	2009e
PROFIT & LOSS					
Revenue	54,737	78,933	112,700	123,750	133,000
Cost of Sales	(35,563)	(51,997)	(74,382)	(81,675)	(87,780)
Gross Profit	19,174	26,936	38,318	42,075	45,220
EBITDA	6,847	8,506	11,837	14,240	15,335
Operating Profit (before GW and except.)	4,486	5,734	9,037	11,440	12,535
Goodwill Amortisation	0	0	0	0	0
Exceptionals	0	(276)	(434)	(500)	(300)
Other	0	0	0	0	0
Operating Profit	4,486	5,458	8,603	10,940	12,235
Net Interest	(773)	(390)	(400)	(400)	(400)
Profit Before Tax (norm)	3,713	5,344	8,637	11,040	12,135
Profit Before Tax (IFRS)	3,713	5,068	8,203	10,540	11,835
Tax	(1,319)	(383)	(2,159)	(3,202)	(3,519)
Profit After Tax (norm)	3,475	4,573	6,477	7,838	8,615
Profit After Tax (IFRS)	2,394	4,685	6,043	7,338	8,315
Average Number of Shares Outstanding (m)	11.7	16.5	19.3	22.2	23.9
EPS - normalised (c)	20.5	27.8	33.6	35.3	36.0
EPS - IFRS (c)	20.5	28.4	31.3	33.1	34.8
Dividend per share (c)	0.0	0.0	15.5	8.9	10.3
Gross Margin (%)	35.0%	34.1%	34.0%	34.0%	34.0%
EBITDA Margin (%)	12.5%	10.8%	10.5%	11.5%	11.5%
Operating Margin (before GW and except.) (%)	8.2%	7.3%	8.0%	9.2%	9.4%
BALANCE SHEET					
Fixed Assets	16,747	36,033	36,000	37,000	38,000
Intangible Assets	13,984	31,669	33,000	34,000	35,000
Tangible Assets	2,763	4,364	3,000	3,000	3,000
Investment in associates	0	0	0	0	0
Current Assets	18,857	26,432	25,006	21,825	23,913
Stocks	135	314	600	700	800
Debtors	11,951	23,289	22,000	22,000	22,000
Cash	6,465	2,565	2,006	-1,325	613
Current Liabilities	(13,123)	(27,530)	(19,500)	(17,000)	(15,000)
Creditors & other liabilities	(9,347)	(22,200)	(18,500)	(16,000)	(14,000)
Short term borrowings	(3,776)	(5,330)	(1,000)	(1,000)	(1,000)
Long Term Liabilities	(4,286)	(8,436)	(2,000)	0	0
Long term borrowings	(2,971)	(465)	(2,000)	0	0
Other long term liabilities	(1,315)	(7,971)	0	0	0
Net Assets	18,195	26,499	39,506	41,825	46,913
CASH FLOW					
Operating Cash Flow	4,106	2,909	9,140	11,640	13,235
Net Interest*	(833)	(492)	(400)	(400)	(400)
Tax	(509)	(841)	(771)	(2,159)	(3,202)
Capex	(2,961)	(3,199)	(3,000)	(3,000)	(3,000)
Acquisitions/disposals	95	(4,080)	(13,400)	(11,720)	(2,720)
Financing	14,120	2,755	10,667	7,300	0
Dividends	0	0	0	(2,992)	(1,976)
Net Cash Flow	14,018	(2,948)	2,236	(1,330)	1,938
Opening net debt/(cash)	14,300	282	3,230	995	2,325
HP finance leases initiated	0	0	0	0	0
Other	0	0	0	0	0
Closing net debt/(cash)	282	3,230	995	2,325	387

Source: Company accounts/Edison Investment Research

Edison Investment Research

Bracton House, 34-36 High Holborn, London, WC1V 6AE ■ tel: +44 (0)20 7190 1760 ■ fax: +44 (0)20 7190 1759 ■ www.edisoninvestmentresearch.co.uk
Registered in England, number 4794244. Edison Investment Research is authorised and regulated by the Financial Services Authority.