

26 May 2010

SQS Software Quality Systems AG

Year End	Revenue (€m)	PBT* (€m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
12/08	142.9	13.1	37.0	9.4	5.0	5.1
12/09	134.3	7.0	17.5	6.0	10.6	3.2
12/10e	141.0	8.8	19.4	6.0	9.5	3.2
12/11e	154.2	11.4	24.6	7.3	7.5	3.9

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles, share-based payments and exceptional items. Translated at £1=€1.167.

Investment summary: Trading update

SQS is trading in line with expectations year-to-date. Key geographies are showing recovery and, in anticipation of continued growth in demand, SQS has increased headcount by 15% since the end of FY09, strengthening both on-shore and off-shore staffing. The managed services order book continues to grow, and with the anticipated recovery underway, we leave our forecasts unchanged.

Trading recovers in key markets

SQS has seen a return to growth in Germany, the UK and the Nordic region. Banking, utilities and oil & gas customers are the most active, with IT budgets being released after a pause in spending. We note that SQS has very little exposure to the UK public sector, and only 10% of FY09 group revenues came from the public sector. Utilisation is back to pre-recession levels, although pricing still remains depressed and is a focus for management in H2. Managed services orders have reached €15m year-to-date, with €7m recognisable in FY10. While managed services orders in FY09 were mainly generated in Switzerland, this year's largest orders have come from Germany and the UK, expanding the adoption of this service.

Continued investment in off-shore

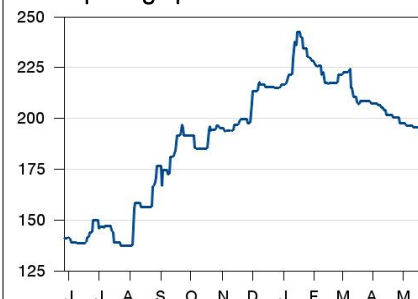
As demand is strengthening and utilisation has recovered, SQS has hired a further 170 consultants (the majority in its off-shore centres) taking the total number of consultants to 1,338. This will impact gross and operating margins in H1, before the new consultants start to generate billable hours from June. The company expects off-shore staff to exceed 30% of total by the end of the year (vs 26.5% at the end of 2009) to support the growing managed services business.

Valuation and forecasts

The recovery in utilisation rates and the growth in the key geographic markets give us confidence that SQS will achieve our FY10 forecasts (ie 4.9% revenue growth) and we maintain our forecasts. SQS is trading at 9.5x FY10e and 7.5x FY11e normalised earnings, marginally below its peer group, with a dividend yield of 3.2% and 3.9% respectively.

Price 187p
Market Cap £51m

Share price graph



Share details

Code SQS
Listing AIM
Sector Software & IT Services
Shares in issue 27.26m

Price

52 week High 242.5p Low 137.5p

Balance Sheet as at 31 December 2009

Debt/Equity (%) N/A
NAV per share (p) 224.7
Net cash (£m) 1.6

Business

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

Valuation

	2009	2010e	2011e
P/E relative	100%	83%	78%
P/CF	6.2	4.5	3.9
EV/Sales	0.4	0.4	0.3
ROE	9%	10%	12%

Geography based on revenues (2008)

UK 25% Europe 75%

Analysts

Katherine Thompson 020 3077 5730
Dan Ridsdale 020 3077 5729
tech@edisoninvestmentresearch.co.uk

Exhibit 1: Financials

	€'000s	2005	2006	2007	2008	2009	2010e	2011e
Year end 31 December								
PROFIT & LOSS								
Revenue		54,737	78,933	121,059	142,903	134,344	140,976	154,227
Cost of Sales		(35,563)	(51,997)	(79,307)	(93,294)	(91,798)	(92,762)	(101,019)
Gross Profit		19,174	26,936	41,752	49,609	42,546	48,214	53,208
EBITDA		6,847	8,507	14,126	17,327	12,493	14,324	16,990
Operating Profit (before GW and except.)		4,486	5,734	10,513	13,462	7,548	9,297	11,963
Amortisation of acquired intangibles		0	0	(241)	(1,140)	(1,557)	(1,557)	(1,557)
Exceptionals		0	(276)	(561)	(1,161)	(432)	(250)	(150)
Other		0	0	0	0	(129)	0	0
Operating Profit		4,486	5,458	9,711	11,160	5,430	7,490	10,256
Net Interest		(773)	(390)	(46)	(319)	(530)	(530)	(530)
Profit Before Tax (norm)		3,713	5,344	10,467	13,143	7,018	8,767	11,433
Profit Before Tax (IFRS)		3,713	5,068	9,665	10,841	5,029	6,960	9,726
Tax		(1,319)	(383)	(2,932)	(4,146)	(1,261)	(2,543)	(3,316)
Profit After Tax (norm)		3,475	4,573	7,535	8,997	5,757	6,225	8,117
Profit After Tax (IFRS)		2,394	4,685	6,733	6,695	3,768	4,418	6,410
Average Number of Shares Outstanding (m)		11.7	16.5	19.1	22.3	26.2	27.5	28.3
EPS - normalised (c)		20.5	27.8	41.5	43.2	21.1	22.6	28.7
EPS - IFRS (c)		20.5	28.4	35.3	30.0	14.4	16.0	22.7
Dividend per share (c)		0.0	0.0	20.0	11.0	7.0	7.0	8.5
Gross Margin (%)		35.0%	34.1%	34.5%	34.7%	31.7%	34.2%	34.5%
EBITDA Margin (%)		12.5%	10.8%	11.7%	12.1%	9.3%	10.2%	11.0%
Operating Margin (before GW and except.) (%)		8.2%	7.3%	8.7%	9.4%	5.6%	6.6%	7.8%
BALANCE SHEET								
Fixed Assets		16,747	36,033	56,598	68,330	62,976	61,892	60,808
Intangible Assets		2,395	3,356	5,999	10,740	10,402	8,818	7,234
Goodwill		11,589	28,313	45,977	52,652	47,513	47,513	47,513
Tangible Assets		2,763	4,364	4,622	4,938	5,061	5,561	6,061
Investment in associates		0	0	0	0	0	0	0
Current Assets		18,857	26,432	35,689	34,650	33,330	38,326	44,116
Stocks		135	314	139	0	0	0	0
Debtors		11,951	23,289	28,173	26,161	24,251	25,500	27,000
Cash		6,465	2,565	7,220	5,753	5,351	8,598	12,888
Current Liabilities		(13,123)	(27,530)	(33,930)	(29,029)	(23,171)	(23,171)	(23,171)
Creditors & other liabilities		(9,347)	(22,200)	(33,224)	(28,023)	(21,515)	(21,515)	(21,515)
Short term borrowings		(3,776)	(5,330)	(706)	(1,006)	(1,656)	(1,656)	(1,656)
Long Term Liabilities		(4,286)	(8,436)	(9,339)	(10,995)	(12,025)	(12,025)	(12,025)
Long term borrowings		(2,971)	(465)	(384)	(732)	(2,112)	(2,112)	(2,112)
Other long term liabilities		(1,315)	(7,971)	(8,955)	(10,263)	(9,913)	(9,913)	(9,913)
Net Assets		18,195	26,499	49,018	62,956	61,610	65,022	69,728
CASH FLOW								
Operating Cash Flow		4,106	2,909	13,540	16,693	9,111	13,075	15,490
Net Interest*		(833)	(492)	(256)	(126)	(603)	(530)	(530)
Tax		(509)	(841)	(1,440)	(3,919)	(1,434)	(1,261)	(2,543)
Capex		(2,961)	(3,199)	(2,930)	(6,024)	(6,273)	(5,500)	(5,500)
Acquisitions/disposals		95	(4,080)	(3,088)	(3,410)	(1,923)	(700)	(700)
Financing		14,120	2,755	3,534	(1,009)	1,478	0	0
Dividends		0	0	0	(4,320)	(2,788)	(1,837)	(1,928)
Net Cash Flow		14,018	(2,948)	9,360	(2,115)	(2,432)	3,247	4,289
Opening net debt/(cash)		14,300	282	3,230	(6,130)	(4,015)	(1,583)	(4,830)
HP finance leases initiated		0	0	0	0	0	0	0
Other		0	0	0	0	0	(0)	(0)
Closing net debt/(cash)		282	3,230	(6,130)	(4,015)	(1,583)	(4,830)	(9,120)

Source: Edison Investment Research, company accounts

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Lincoln House, 296-302 High Holborn, London, WC1V 7JH ■ tel: +44 (0)20 3077 5700 ■ fax: +44 (0)20 3077 5750 ■ www.edisoninvestmentresearch.co.uk
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