

14 May 2009

SQS Software Quality Systems AG

Year End	Revenue (€m)	PBT* (€m)	EPS* ** (p)	DPS (p)	P/E (x)	Yield (%)
12/07	121.1	10.5	37.2	17.9		
12/08	142.9	13.1	38.7	9.9		
12/09e	142.0	7.0	17.0	5.4		
12/10e	147.9	8.8	20.3	6.3		

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

** Historic EPS are adjusted to reflect actual tax and interest rates rather than reported and an exchange rate of £0.9/euro as at 14 May 2009.

Investment summary: Reality (finally) bites

SQS has been a stand-out performer both operationally and in share price terms for a considerable period of time. However, the impact of the global recession has finally resulted in a set-back and H109 results will fall well short of expectations. On the plus side, new client wins are still driving the top line and the outlook for H209 should see a recovery in margins. Meanwhile, the long term investment case is still attractive.

Trading update: tail off in H1

Trading during the early part of the current financial year was robust in terms of both new business wins and profitability. However, in the latter part of H1 the impact of global recession has seen a growing trend for customers to delay implementation and suspend live IT projects. This has had a knock-on effect on utilisation levels for consultants and therefore margins. The impact has been exacerbated by pricing pressure in the core German, UK and Nordic markets.

Impact on forecasts: interim profits fall

The top line performance of the group still demonstrates the strong business case for independent software testing with first half turnover expected to grow by 6% in local currency terms (2% after exchange rate effects). This is well ahead of an IT market which Gartner expects to contract by 2% in 2009. However, there is no escaping the impact on profitability of today's update and H1 profits are likely to be around half the previous year's. The overall impact sees us reduce our sales and PBT estimates for FY09 from €155m to €142m and from €13.8m to €7.0m respectively. In FY10, our estimate for turnover falls from €163.8m to €148m and PBT from €14.6m to €8.8m. EPS and DPS forecasts fall by approximately 50% in both FY09 and FY10.

Price 165p
Market Cap €m

Share price graph

Share details

Code SQS
Listing AIM
Sector Software & IT Services
Shares in issue 26.19m

Price

52 week High Low
p p

Balance Sheet as at 31 December 2008

Debt/Equity (%) N/A
NAV per share (€) 2.82
Net cash (€m) 5.1

Business

SQS is the world's biggest 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

	2008	2009e	2010e
P/E			
Relative			
P/CF			
EV/Sales			
ROE			

Analysts

Jason Holden 020 7190 1755
jholden@edisoninvestmentresearch.co.uk
Andrew Bryant 020 3077 5729
abryant@edisoninvestmentresearch.co.uk

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Outlook and valuation

The top line at SQS is still significantly outperforming the market (44 new client wins in 2009), in part as a consequence of the strong growth still being seen in the off shore segment. In addition, the company still has an un-gearred balance sheet and is cash generative. After today's significant share price fall the P/E is intrinsically cheap below 10x and supported by a DCF of 250p+. The potential for SQS to make market share gains in the outsourced testing industry still holds out significant long term upside.

Exhibit 1: Financials

Year end 31 December	€000s	2006	2007	2008	2009e	2010e
PROFIT & LOSS						
Revenue		78,933	121,059	142,903	142,000	147,903
Cost of Sales		(51,997)	(79,307)	(93,294)	(93,010)	(96,137)
Gross Profit		26,936	41,752	49,609	48,990	51,766
EBITDA		8,506	14,126	17,328	10,810	12,537
Operating Profit (before GW and except.)		5,734	10,513	13,462	6,944	8,671
Goodwill Amortisation		0	(241)	(1,140)	(1,140)	(1,140)
Exceptionals		(276)	(561)	(1,161)	(250)	(250)
Other		0	0	0	0	0
Operating Profit		5,458	9,711	11,160	5,553	7,280
Net Interest		(390)	(46)	(319)	100	100
Profit Before Tax (norm)		5,344	10,467	13,143	7,044	8,771
Profit Before Tax (IFRS)		5,068	9,665	10,841	5,653	7,380
Tax		(383)	(2,932)	(4,146)	(2,043)	(2,543)
Profit After Tax (norm)		4,573	7,535	8,997	5,001	6,227
Profit After Tax (IFRS)		4,685	6,733	6,695	3,611	4,837
Average Number of Shares Outstanding (m)		16.5	19.1	22.3	26.3	27.5
EPS - normalised (c)		27.8	41.5	43.2	19.0	22.6
EPS - IFRS (c)		28.4	35.3	30.0	13.7	17.6
Dividend per share (c)		0.0	20.0	11.0	6.0	7.0
Gross Margin (%)		34.1%	34.5%	34.7%	34.5%	35.0%
EBITDA Margin (%)		10.8%	11.7%	12.1%	7.6%	8.5%
Operating Margin (before GW and except.) (%)		7.3%	8.7%	9.4%	4.9%	5.9%
BALANCE SHEET						
Fixed Assets		36,033	56,598	68,330	68,330	68,330
Intangible Assets		31,669	51,976	63,392	63,392	63,392
Tangible Assets		4,364	4,622	4,938	4,938	4,938
Investment in associates		0	0	0	0	0
Current Assets		26,432	35,689	34,650	32,054	33,349
Stocks		314	139	0	200	200
Debtors		23,289	28,173	26,161	30,800	31,000
Cash		2,565	7,220	5,753	554	1,648
Current Liabilities		(27,530)	(33,930)	(29,029)	(32,700)	(32,700)
Creditors & other liabilities		(22,200)	(33,739)	(28,571)	(32,500)	(32,500)
Short term borrowings		(5,330)	(191)	(458)	(200)	(200)
Long Term Liabilities		(8,436)	(9,339)	(10,995)	(9,000)	(9,000)
Long term borrowings		(465)	(105)	(175)	0	0
Other long term liabilities		(7,971)	(9,234)	(10,820)	(9,000)	(9,000)
Net Assets		26,499	49,018	62,956	58,684	59,979
CASH FLOW						
Operating Cash Flow		2,909	13,291	16,693	9,900	12,337
Net Interest*		(492)	(497)	(192)	100	100
Tax		(841)	(1,440)	(3,919)	(4,146)	(2,043)
Capex		(3,199)	(2,930)	(6,024)	(5,000)	(5,000)
Acquisitions/disposals		(4,080)	(3,578)	(3,410)	(2,720)	(2,720)
Financing		2,755	5,308	(772)	0	0
Dividends		0	0	(4,180)	(2,900)	(1,580)
Net Cash Flow		(2,948)	10,154	(1,804)	(4,766)	1,094
Opening net debt/(cash)		282	3,230	(6,924)	(5,120)	(354)
HP finance leases initiated		0	0	0	0	0
Other		0	0	0	0	0
Closing net debt/(cash)		3,230	(6,924)	(5,120)	(354)	(1,448)

Source: Company accounts/Edison Investment Research

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Edison Investment Research

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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