Review

Edison investment research

8 September 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	36.2	17.4	4.8	10.0
12/08	142.9	13.1	37.7	9.6	4.6	5.5
12/09e	142.0	7.0	16.6	5.2	10.5	3.0
12/10e	147.9	8.8	19.7	6.1	8.9	3.5

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/€ as at 5 September 2009.

Investment summary: Keep the faith

Interim results reveal that the company is on track to meet full year expectations that were lowered in May. Market conditions have stabilised and management have successfully taken steps to improve profitability. The shares have rebounded by 30%+ since their lows, but the long-term investment case is still a positive one and the valuation is attractive on a number of levels.

Interim results: Figures lend confidence for full year

May's trading statement warned that the latter part of H1 had seen a slowdown in the two key markets of Germany and the UK. The interim figures therefore contained few surprises and revealed that group turnover fell slightly by 2% to €67.5m. Restructuring costs of €0.6m impacted adjusted PBT, which fell by more than 50% to €2.7m; although these initiatives are now complete and the benefit will be seen in H2. The fall in profitability principally reflected a fall in gross margins from 34.7% to 29.4%, largely as a consequence of lower utilisation levels and to a degree, pricing. Normalised EPS – on the same basis as reported PBT– declined from €0.23 to €0.08.

Outlook: Still intrinsic growth

Given the failure rate of IT projects, the market for independent software testing is likely to continue to expand and there is a significant opportunity for SQS – the largest global player – to increase its market share. Even in the absence of growth in the overall market for testing, if the independent sector grows to 20% of the total and SQS's share rises to 12%, this could see the company generating 50p+ of earnings on a 3 to 5 year view. Meanwhile, the strategy to significantly grow the proportion of 'Managed Services' contracts will increase earnings quality and visibility.

Valuation and conclusion

Despite a difficult H109, the interim figures do lend confidence to the expectation that SQS will meet full year forecasts. In the near term – and despite a 30%+ bounce in the share price from its lows – this only gives rise to a P/E of around 10x in the current year. Given the attractions of the free cash flows apparent in a DCF value of 250p+, and a positive long-term future for the independent testing sector, there remains a positive investment case to be made.

Price	174.5p
Market Cap	£46m

Share price graph

Share details

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

Price

52 week	High	Low
	322.5p	137.5p

Balance Sheet as at 30 June 2009

Debt/Equity (%)	1.9
NAV per share (€)	2.35
Net cash (€m)	1.2

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	42%	111%	102%
P/CF	2.6	5.1	4.3
EV/Sales	0.3	0.4	0.3
ROE	15%	9%	10%

Analysts

Jason Holden 020 3077 5730
jholden@edisoninvestmentresearch.co.uk

Andrew Bryant 020 3077 5729
abryant@edisoninvestmentresearch.co.uk

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

Investment summary: Long-term growth potential

Company description

SQS is the largest global provider of independent software testing and quality management. The vast majority of the group's revenues (94.8% in H109) 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 27 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 – including Scandinavia – as well as South Africa and India.

Growth market: Potential value upside

The software testing industry is worth approximately €13bn and only about 12% of this market is currently contracted out. Given forecast revenues of €142m in FY09, SQS has less than a 10% share of its addressable market. Utilising industry estimates, management believes that it is realistic to assume that the percentage of the testing industry which is outsourced could grow to around 20% in the medium term and assuming that SQS's share could potentially rise to 12% over the same period, this could see current revenues more than double to €300m+.

Assuming margins progress to a more normalised 8% would imply operating profits of c €25m and given zero interest payments and a 29% tax charge, would leave net earnings of €17.8m and in sterling terms, £15.5m or 59p per share. This suggests the stock could be trading on approximately 3x EPS on something like a three- to five-year view and gives an indication as to the significant upside potential.

Strategy and outlook

Given recent events, there is clearly an element of rebuilding to be done in restoring investors confidence, despite the fairly compelling arguments surrounding SQS's position in a fundamentally growth driven market. In the near term this is likely to mean very much a focus on organic growth, especially given the geographic footprint is now much more established.

In addition, management has also declared its intention to grow the proportion of longer-term managed services contracts and has set a target of having 50% of all customer accounts on this basis over the next three years. This will increase visibility and the predictability of the earnings stream given both the typical length of such contracts and the longer notice periods involved. At the same time, there are likely to be a growing proportion of on/off shore blended contracts given a market proposition which can deliver consistent levels of service at a reduced cost.

Fundamentally we remain of the view that the market for independent software testing will continue to grow and that SQS's pre-eminent position offers a positive long-term investment case.

Interim results H109

Undoubtedly a tough H1 for SQS, when trading in the latter part of the half year reflected the consequences of global recession, slippage in orders and the suspension of live IT projects. Consultant utilisation levels and profitability suffered and pricing also came under pressure. However, new business wins have remained healthy, cost cutting measures have now begun to take effect and utilisation levels are recovering in H2.

Exhibit 1: Summary of interim results for the six months to 30 June 2009

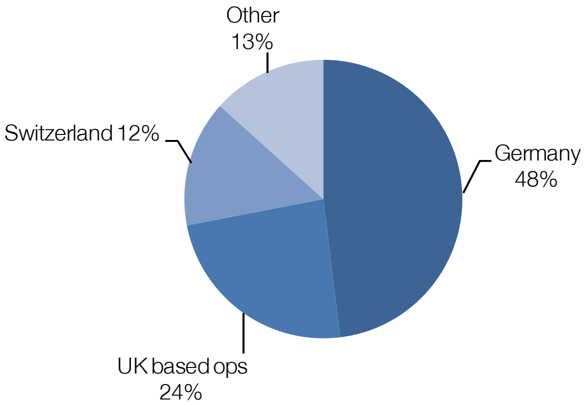
€m	2008	2009	%
	Six months to 30 June	Six months to 30 June	
Turnover	68.9	67.5	-2
Gross margin (%)	34.7	29.4	-5%pts
EBITDA	8.5	4.9	-42
Profit/(loss) before tax (norm)	6.7	2.7	-59
EPS normalised (€)	0.23	0.08	-65
Cash/(net debt)	-1.1	-1.2	+9

Source: SQS

Geographic review

May's trading statement flagged that H1 results were likely to fall well short of expectations and the figures themselves confirm the problematic conditions witnessed – particularly in the latter part of the first half. Group turnover fell slightly by 2% to €67.5m and principally reflected a slowdown in the two key markets of Germany and the UK. Germany is still the biggest contributor to the top line, representing c 50% of revenues, and sales (entirely organic) fell 4.5% in H1 to €32.4m. This largely reflected the impact on IT spend (ie the suspension/deferral of projects) of an overall contraction in GDP.

Exhibit 2: Geographic analysis H109



Source: Edison Investment Research

The UK suffered from a similar backdrop and witnessed a significant but more expected fall in revenues of 21.3% in sterling and 32.5% as reported in euros, to €16.1m. Part of the reduction however, reflected the assignment of UK based consultants to other regions and action was taken at a relatively early stage to reduce headcount.

The relocation of consultants helped boost revenues in Switzerland to €9.9m (+44.3%), although conditions there were generally were more favourable. There was significant growth in the other

European markets to €9.0m (+118%), the majority of which was due to the inclusion of the Validate acquisition made in July 2008.

SQS took steps to meet the challenges presented by the testing market backdrop and the restructuring programme has led to a range of cost saving measures. This principally involved a reduction in headcount in the on-shore operations with 55 fewer consultants, which in itself has led to improved utilisation. Forty-three off-shore consultants were added – albeit at significantly lower cost – and consequently group employees fell slightly during the half.

Financial analysis

The cost of the streamlining initiatives highlighted above was €0.6m and adding this back to the adjusted PBT figure, above, would have produced an outcome of €3.3m for the half rather than the reported €2.7m (adjusted for amortisation and pro forma interest). Nonetheless, on either basis, normalised pre-tax profits for H109 still fell by more than 50% and reflected a fall in gross margins from 34.7% to 29.4%, largely as a consequence of lower utilisation levels and, to a degree, pricing.

This in turn reflected the fact that although action was taken to reduce headcount in response to falling utilisation levels for consultants, there was inevitably a time lag for this to impact costs while revenues continued to fall. Normalised EPS – on the same basis as reported PBT above – declined from €0.23 to €0.08.

G&A expenses fell slightly as a proportion of sales to 15.0%, reflecting in part the efficiency impact of successfully integrating acquisitions while sales and marketing costs rose 12.5% to €5.4m to reflect increased investment. As has become typical, there was a small net debt position of €1.2m – largely as a consequence of tax and dividend payments – which was very similar to the previous year. The company still expects to report net cash at the year end.

Operational highlights

Although trading conditions were clearly difficult during H1, there were a number of new contract wins with the blended on and off-shore testing offering proving to be particularly successful. The ability to offer high levels of service at a competitive pricing point gives the group a distinct advantage in the independent testing sector, where a lack of scale must hamper some competitors. In total, the group secured 82 new clients in H109.

Some notable successes in terms of new business wins include the recent signing of a one-year £0.5m on/off-shore managed service contract with the consumer division of a leading financial services provider and a similar type and length of contract with a leading UK gas supplier. Also of note was a new contract with Telenor – a major provider of telecommunication services in Scandinavia – covering both its fixed-line and mobile value chains.

Sector wise, greater stability in the Financial Services sector has no doubt helped secure a number of business wins in several European markets, and the food, retail and the legal industries have also exhibited some positive trends. SQS now operates across 27 industry verticals and greater penetration of these will be a key feature going forward.

Outlook

One of the trends witnessed in H1 was the suspension of a number of major live IT projects by customers. Although conditions remain unpredictable, there are signs of greater stability in both the key German and UK markets and during H2 a number of these projects have recommenced. In addition, there have been encouraging levels of new business wins.

SQS has clearly been innovative in the marketplace with not only its on/off-shore blended offering but also meeting the needs of customers for more results driven outcomes rather than the more typical payment of daily rates. This 'Managed Testing Services' proposition also involves longer-term contracts which give greater levels of visibility over future earnings streams; the Swiss market in particular has been receptive to this offering and indeed has been very robust generally despite the wider international economic backdrop. Managed service type accounts currently represent less than 10% of business operations, but strategy will now focus on increasing this to c 50% over the next three years.

Forecasts

At the time of the trading update in May we significantly reduced our forecasts to reflect the deterioration in trading conditions and profitability described above. However, having now seen some stabilisation in the market backdrop in SQS's principal territories and with steps having been taken to improve margins, we believe that estimates for FY09 are well based. This is not to say that uncertainty does not continue to affect visibility going forward, but a growing proportion of long-term contracts, an existing well established customer base and a lower cost structure should lend confidence as the process of rebuilding credibility continues.

Valuation and conclusion

After a sustained period of outperformance, it was inevitable that May's profit warning would bring about a sharply adverse reaction in the share price. However, H109 results are an important step in rebuilding investor confidence and our forecasts for the full year look well underpinned. Given such positive long-term underlying growth prospects, the shares are attractively valued from an earnings perspective, while the DCF underscores the value of the cash flows.

Rebound in earnings

FY09 clearly represents a depressed level of earnings, but, even so, the P/E is still only around the 10x mark and not unappealing in its own right. An expected rebound in profitability in FY10 reduces the multiple to 8.9x and as the bottom line works its way back up, there is considerable scope to see a contraction in the rating against the backdrop of a genuine growth market. Meanwhile, although the dividend has been rebased to reflect the fall in earnings in the current year there is still some support in a predicted yield of c 3%.

DCF

In terms of intrinsic value, our DCF analysis below highlights the potential which exists given the predicted value of future cash flows. Based on our typically ultra conservative discount rate of 15%, this reveals an equity value of 266p, some 50% above the current share price. Given that this analysis is based on a starting point that reflects the impact of currently depressed earnings streams, there is also scope for this value to increase moving forward.

The lack of capex requirements and a fairly flexible labour force – particularly in Germany given state aid to fund companies retaining unutilised staff at minimum costs – means that the SQS business model is fundamentally cash generative and this forms the basis for the assumptions reflected in the summary below.

Exhibit 3: DCF Valuation based on WACC of 15%

Discount Rate	15%
NPV Forecast Period €m	38
Growth rate in perpetuity	5%
NPV Terminal Value €m	41.9
Net cash 2008 €m	0.4
Equity Value per share (pence)	266p

Source: Edison Investment Research

Conclusion

Although the share price has already begun to reflect some renewed optimism following the events in May – the shares have rebounded by 30% from their lows – there is still an intrinsically positive growth story to the outlook for the market for independent software testing. From profitability levels that are clearly depressed, this potential is not reflected in either earnings based multiples or the value of future cashflows, as reflected in the DCF analysis above.

Exhibit 4: Financials

€'000s	2006	2007	2008	2009e	2010e
Year end 31 December					
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

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
Registered in England, number 4794244. Edison Investment Research is authorised and regulated by the Financial Services Authority.