Edison investment research

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SQS Software Quality Systems AG

Year End	Revenue (€m)	PBT* (€m)	EPS* ** (p)	DPS (p)	PE (x)	Yield (%)
12/06	78.9	5.3	22.1	0.0	13.7	N/A
12/07	121.1	10.5	32.8	15.9	9.2	5.2
12/08e	139.9	12.8	31.5	9.6	9.6	3.1
12/09e	155.4	14.9	33.2	10.4	9.1	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 £0.79/euro as at 11 June 2008.

Investment summary: Validates strategy

The acquisition of Scandinavian based Validate for €16.4m is consistent with the strategy of expanding the European footprint. Previous similarly motivated acquisitions have delivered and management's track record should give investors confidence. The much smaller purchase of Verisoft in India adds another dimension to the offshoring capability and the senior management of both businesses will remain on board.

Acquisitions

SQS is acquiring Swedish based software testing and quality management business Validate Technology for a maximum consideration of €16.4m. The initial payment is €2.7m in cash and the issue of 1.2m shares worth €4.6m. A three-year earn out could see a further amount payable in cash and shares of €9.1m. Validate also operates in Finland and Norway and geographically is an excellent complementary fit for SQS. 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.

Forecasts

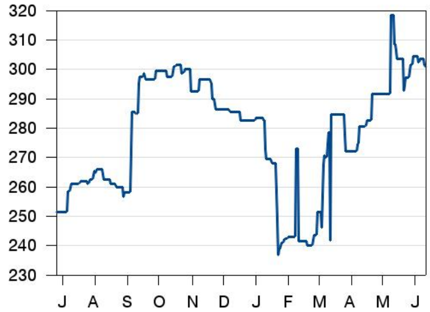
Both deals are expected to be earnings enhancing although we have been somewhat more conservative in forecasts than implied by the maximum consideration payable for Validate. Given that the financial impact of Verisoft is not overly significant – turnover was €1.2m in 2008 – Validate is responsible for the vast majority of our upgrade in PBT of €0.4m in 2008 and €1.0m in 2009 (ie underlying EPS rises c 3% in FY09).

Valuation and conclusion

The SQS share price continues to defy recent market volatility and yet the forecast PE remains below 10x in each of the next two years. The two acquisitions described above reflect a coherent strategy to further develop the market leadership of SQS in a field where intrinsic prospects remain favourable. Although the company would not be immune to a downturn in total IT expenditure, the secular growth present in the testing market is of great defensive value and is supported by a prospective dividend yield of 3%+ and our DCF value of 400p+.

Price	301.5p
Market Cap	£65m

Share price graph



Share details

Code	SQS
Listing	AIM
Sector	Software & IT Services
Shares in issue	21.6m

Price

52 week	High	Low
	318.5p	236.5p

Balance Sheet as at 31 December 2007

Debt/Equity (%)	N/A
NAV per share (€)	2.56
Net cash (€m)	6.9

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

	2007	2008e	2009e
P/E Relative	66%	86%	88%
P/CF	5.5	7.2	5.5
EV/Sales	0.5	0.6	0.6
ROE	16%	16%	17%

Geography based on revenues

UK	Europe	US	Other
40%	60%	0%	0%

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

Exhibit 1: Financials

€'000s	2005	2006	2007	2008e	2009e
Year end 31 December					
PROFIT & LOSS					
Revenue	54,737	78,933	121,059	139,900	155,400
Cost of Sales	(35,563)	(51,997)	(79,307)	(90,236)	(99,456)
Gross Profit	19,174	26,936	41,752	49,665	55,944
EBITDA	6,847	8,506	14,124	16,281	18,390
Operating Profit (before GW and except.)	4,486	5,734	10,513	12,670	14,779
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	11,430	13,789
Net Interest	(773)	(390)	(46)	100	100
Profit Before Tax (norm)	3,713	5,344	10,467	12,770	14,879
Profit Before Tax (IFRS)	3,713	5,068	9,665	11,530	13,889
Tax	(1,319)	(383)	(2,932)	(3,703)	(4,315)
Profit After Tax (norm)	3,475	4,573	7,535	9,066	10,564
Profit After Tax (IFRS)	2,394	4,685	6,733	7,826	9,574
Average Number of Shares Outstanding (m)	11.7	16.5	19.1	22.8	25.2
EPS - normalised (c)	20.5	27.8	41.5	39.7	42.0
EPS - IFRS (c)	20.5	28.4	35.3	34.3	38.0
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%	11.6%	11.8%
Operating Margin (before GW and except.) (%)	8.2%	7.3%	8.7%	9.1%	9.5%
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	31,026	36,405
Stocks	135	314	139	200	200
Debtors	11,951	23,289	28,173	30,000	31,000
Cash	6,465	2,565	7,220	376	4,705
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	55,452	60,831
CASH FLOW					
Operating Cash Flow	4,106	2,909	13,291	12,154	17,390
Net Interest*	(833)	(492)	(497)	100	100
Tax	(509)	(841)	(1,440)	(2,932)	(3,703)
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)	(2,737)
Net Cash Flow	14,018	(2,948)	10,154	(6,749)	4,330
Opening net debt/(cash)	14,300	282	3,230	(6,924)	(176)
HP finance leases initiated	0	0	0	0	0
Other	0	0	0	0	0
Closing net debt/(cash)	282	3,230	(6,924)	(176)	(4,505)

Source: Company accounts/Edison Investment Research