

28 November 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	15.8	0.0	18.2	N/A
12/06	78.9	5.3	20.0	0.0	14.4	N/A
12/07e	117.2	9.4	26.4	10.9	11.0	3.8
12/08e	128.8	12.0	27.5	6.4	10.4	2.2

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 £0.72/Euro as at 26 November 2007.

Investment summary: Higher still

The year end trading update confirms that the rapid underlying expansion witnessed in H1 has continued into H2. Organic growth of 25% has now been sustained throughout the period and reflects both increased pricing power as well as strong growth in the market for independent software testing. Forecasts need to move even higher still and although the shares have been star performers in a volatile equity market, the valuation is still attractive.

Momentum continues into H2

Interim results in September raised the bar for organic growth with a reported +25% and this momentum has continued to into H2. As well as ongoing improvements in pricing power in the principal UK and German markets, new contract wins continue to demonstrate the compelling commercial logic for independent software testing and SQS's market leadership position is generating premium growth.

Earnings quality

During Q3, SQS won 43 clients to add to the 64 won in H1, more than matching the 100 gained in all of 2006. Not only does the client base reflect a significant proportion of both the DAX 30 and FTSE-100 – approaching 50% of the overall number of companies – but also an increasing proportion of long term contracts.

Impact on forecasts

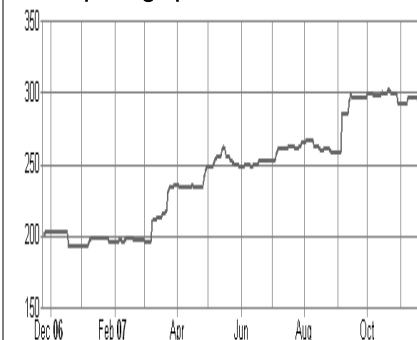
Although we only recently raised estimates, the sustained underlying momentum has meant we have increased forecasts again: turnover rises by approximately 4% in each of the next two years and given a further improvement in margins, this translates into a 9% advance in PBT. Following the appreciation of the euro since our last note, this then delivers a c.15% upgrade in sterling denominated eps.

Outlook and valuation

In choppy stock market waters SQS is a stand-out case with a strong business case, substantial organic growth and a relatively undemanding valuation. A p/e of just 11x in 2007 followed by 10.4x in 2008 leaves plenty of room for upside, while a DCF of 384p also suggests the shares can continue their recent run.

Price 287p
Market Cap £62m

Share price graph



Share details

Code SQS
Listing AIM
Sector Software & IT Services
Shares in issue 21.54m

Price

52 week High 301.5p Low 192.5p

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	103%	88%	90%
P/CF	22.6	7.7	7.0
EV/Sales	0.9	0.7	0.7
ROE	17%	17%	20%

Geography based on revenues FY06

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

Analyst

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Exhibit 1: Financials

Year-end 31st December	'000s	2005	2006	2007e	2008e	2009e
PROFIT & LOSS						
Revenue		54,737	78,933	117,200	128,750	138,000
Cost of Sales		(35,563)	(51,997)	(76,180)	(83,044)	(88,320)
Gross Profit		19,174	26,936	41,020	45,706	49,680
EBITDA		6,847	8,506	12,580	15,163	16,353
Operating Profit (before GW and except.)		4,486	5,734	9,780	12,363	13,553
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	9,346	11,863	13,253
Net Interest		(773)	(390)	(400)	(400)	(400)
Profit Before Tax (norm)		3,713	5,344	9,380	11,963	13,153
Profit Before Tax (IFRS)		3,713	5,068	8,946	11,463	12,853
Tax		(1,319)	(383)	(2,345)	(3,469)	(3,814)
Profit After Tax (norm)		3,475	4,573	7,035	8,493	9,338
Profit After Tax (IFRS)		2,394	4,685	6,601	7,993	9,038
Average Number of Shares Outstanding (m)		11.7	16.5	19.1	22.2	23.9
EPS - normalised (c)		20.5	27.8	36.8	38.3	39.1
EPS - IFRS (c)		20.5	28.4	34.6	36.0	37.8
Dividend per share (c)		0.0	0.0	15.5	8.9	10.3
Gross Margin (%)		35.0%	34.1%	35.0%	35.5%	36.0%
EBITDA Margin (%)		12.5%	10.8%	10.7%	11.8%	11.8%
Operating Margin (before GW and except.) (%)		8.2%	7.3%	8.3%	9.6%	9.8%
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	25,749	23,336	26,174
Stocks		135	314	600	700	800
Debtors		11,951	23,289	22,000	22,000	22,000
Cash		6,465	2,565	2,749	186	2,874
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	40,249	43,336	49,174
CASH FLOW						
Operating Cash Flow		4,106	2,909	9,883	12,563	14,253
Net Interest*		(833)	(492)	(400)	(400)	(400)
Tax		(509)	(841)	(771)	(2,345)	(3,469)
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	(2,961)	(1,976)
Net Cash Flow		14,018	(2,948)	2,979	(562)	2,688
Opening net debt/(cash)		14,300	282	3,230	252	814
HP finance leases initiated		0	0	0	0	0
Other		0	0	0	0	0
Closing net debt/(cash)		282	3,230	252	814	(1,874)

Source: Company accounts/Edison Investment Research

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