

19 January 2009

## SQS Software Quality Systems AG

Year End	Revenue (€m)	PBT* (€m)	EPS* ** (p)	DPS (c)	P/E (x)	Yield (%)
12/06	78.9	5.3	25.1	0.0	9.0	N/A
12/07	121.1	10.5	37.3	20.0	6.0	8.0
12/08e	143.5	13.1	36.4	12.0	6.2	4.8
12/09e	155.0	13.4	32.5	13.0	6.9	5.2

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 €0.9/£ as at 14 January 2009.

### Investment summary: A sterling performance

A strong momentum in underlying trading has been maintained throughout FY08 and the year end update confirms the business is still delivering powerful organic top line growth. Despite substantial currency movements, SQS should comfortably meet our EPS expectations, although FY09 estimates have been pared back. Overall, the outlook remains positive for the global market leader in a secular growth industry.

### Strategic and operational advances in FY08

All the major geographic regions delivered underlying sales growth of 15-20% in FY08 with the largest market, Germany, being particularly strong. The business critical nature and compelling arguments in favour of independent software testing continue to provide a positive backdrop even given the potential impact of current economic uncertainty. There were also two important strategic acquisitions during the year; Swedish-based Validate was purchased for €16.4m to continue the expansion of the European footprint, while Verisoft in India enhances the off-shoring capability.

### Currency impact and outlook

With approximately one third of revenues in sterling, the slide of the pound against the euro will inevitably hold back reported euro growth from the FY08 numbers and even more so in FY09. Nonetheless, given the opposite impact on our sterling EPS forecast, we have only reduced our FY09 EPS estimate by 5%. Since the vast majority of any currency impact is translational, as costs are generally proportionate to sales across the relevant geographies, swings in exchange rates should not play too big a role in the business case. Of more fundamental interest is a strong trend to out-sourcing software testing that shows no sign of letting up.

### Valuation

Although we would not overstate the business impact of the depreciation of sterling for SQS, there is clearly a significant impact on our valuation metrics. With EPS around 36p, a P/E of 6x is clearly very attractive in its own right given such positive fundamentals. Supported by a 5% yield and a DCF approaching 400p, SQS continues to be a stand-out investment case in the smaller tech space; our confidence in future outperformance is undiminished.

Price 225p  
Market Cap £58m

#### Share price graph



#### Share details

Code SQS  
Listing AIM  
Sector Software & IT Services  
Shares in issue 26.18m

#### Price

52 week High 322.5p Low 201.5p

#### Balance Sheet as at 30 June 2008

Debt/Equity (%) 2.2  
NAV per share (€) 2.16  
Net debt (€m) 1.1

#### Business

SQS is the largest independent provider of software testing and quality management services. 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	43%	79%	78%
P/CF	3.6	4.6	4.1
EV/Sales	0.3	0.4	0.4
ROE	16%	17%	16%

#### Geography based on revenues

	UK	Europe	US	Other
	33%	65%	0%	2%

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

**Exhibit 1: Financials**

Year end 31 December	€'000s	2005	2006	2007	2008e	2009e
<b>PROFIT &amp; LOSS</b>						
<b>Revenue</b>		<b>54,737</b>	<b>78,933</b>	<b>121,059</b>	<b>143,500</b>	<b>155,000</b>
Cost of Sales		(35,563)	(51,997)	(79,307)	(92,558)	(99,200)
Gross Profit		19,174	26,936	41,752	50,943	55,800
<b>EBITDA</b>		<b>6,847</b>	<b>8,506</b>	<b>14,124</b>	<b>16,576</b>	<b>16,956</b>
<b>Operating Profit (before GW and except.)</b>		<b>4,486</b>	<b>5,734</b>	<b>10,513</b>	<b>12,965</b>	<b>13,345</b>
Goodwill Amortisation		0	0	(241)	(740)	(740)
Exceptionals		0	(276)	(561)	(500)	(250)
Other		0	0	0	0	0
<b>Operating Profit</b>		<b>4,486</b>	<b>5,458</b>	<b>9,711</b>	<b>11,725</b>	<b>12,355</b>
Net Interest		(773)	(390)	(46)	100	100
<b>Profit Before Tax (norm)</b>		<b>3,713</b>	<b>5,344</b>	<b>10,467</b>	<b>13,065</b>	<b>13,445</b>
<b>Profit Before Tax (IFRS)</b>		<b>3,713</b>	<b>5,068</b>	<b>9,665</b>	<b>11,825</b>	<b>12,455</b>
Tax		(1,319)	(383)	(2,932)	(3,789)	(3,899)
<b>Profit After Tax (norm)</b>		<b>3,475</b>	<b>4,573</b>	<b>7,535</b>	<b>9,276</b>	<b>9,546</b>
<b>Profit After Tax (IFRS)</b>		<b>2,394</b>	<b>4,685</b>	<b>6,733</b>	<b>8,036</b>	<b>8,556</b>
Average Number of Shares Outstanding (m)		11.7	16.5	19.1	22.9	26.5
<b>EPS - normalised (c)</b>		<b>20.5</b>	<b>27.8</b>	<b>41.5</b>	<b>40.4</b>	<b>36.1</b>
<b>EPS - IFRS (c)</b>		<b>20.5</b>	<b>28.4</b>	<b>35.3</b>	<b>35.0</b>	<b>32.3</b>
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%	10.9%
Operating Margin (before GW and except.) (%)		8.2%	7.3%	8.7%	9.0%	8.6%
<b>BALANCE SHEET</b>						
<b>Fixed Assets</b>		<b>16,747</b>	<b>36,033</b>	<b>56,598</b>	<b>65,126</b>	<b>65,126</b>
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
<b>Current Assets</b>		<b>18,857</b>	<b>26,432</b>	<b>35,689</b>	<b>31,321</b>	<b>35,165</b>
Stocks		135	314	139	200	200
Debtors		11,951	23,289	28,173	30,000	31,000
Cash		6,465	2,565	7,220	671	3,465
<b>Current Liabilities</b>		<b>(13,123)</b>	<b>(27,530)</b>	<b>(33,930)</b>	<b>(31,700)</b>	<b>(31,700)</b>
Creditors & other liabilities		(9,347)	(22,200)	(33,739)	(31,500)	(31,500)
Short term borrowings		(3,776)	(5,330)	(191)	(200)	(200)
<b>Long Term Liabilities</b>		<b>(4,286)</b>	<b>(8,436)</b>	<b>(9,339)</b>	<b>(9,000)</b>	<b>(9,000)</b>
Long term borrowings		(2,971)	(465)	(105)	0	0
Other long term liabilities		(1,315)	(7,971)	(9,234)	(9,000)	(9,000)
<b>Net Assets</b>		<b>18,195</b>	<b>26,499</b>	<b>49,018</b>	<b>55,747</b>	<b>59,591</b>
<b>CASH FLOW</b>						
<b>Operating Cash Flow</b>		<b>4,106</b>	<b>2,909</b>	<b>13,291</b>	<b>12,449</b>	<b>15,956</b>
Net Interest*		(833)	(492)	(497)	100	100
Tax		(509)	(841)	(1,440)	(2,932)	(3,789)
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)	(2,754)
Net Cash Flow		14,018	(2,948)	10,154	(6,453)	2,794
<b>Opening net debt/(cash)</b>		<b>14,300</b>	<b>282</b>	<b>3,230</b>	<b>(6,924)</b>	<b>(471)</b>
HP finance leases initiated		0	0	0	0	0
Other		0	0	0	0	0
<b>Closing net debt/(cash)</b>		<b>282</b>	<b>3,230</b>	<b>(6,924)</b>	<b>(471)</b>	<b>(3,265)</b>

Source: Company accounts/Edison Investment Research

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