

5 July 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	14.7	0.0	17.1	N/A
12/06	78.9	5.3	18.7	0.0	13.5	N/A
12/07e	104.5	7.9	20.5	10.4	12.3	4.1
12/08e	115.0	10.1	21.1	6.0	11.9	2.4

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 £1: 0.67 Euros as at Monday 2 July 2007.

Investment summary: Top up

The half-year trading update confirms that the momentum behind organic top line growth of 20% in Q1 has been maintained. Consequently we have raised our forecast for turnover although, prudently, our profit estimates remain unchanged, mainly to reflect the margin impact of recruiting more consultants. Overall, SQS is in good shape and the fundamentals are well supported by an attractive valuation.

Half-year trading update

The increased investment in new consultants supports a momentum which continues to drive the top-line; there were 64 client wins in H1 compared to 100 in the whole of 2006. With the finance and automotive sectors particularly strong, we are now forecasting organic revenue growth of 20%+ in H1 compared to 18% in full year '06.

Forecasts

We now expect revenues of €104.5m in 2007 (vs. €95m previously), rising to €115m in 2008 (€104m). However, we have maintained our profits estimates in both years to reflect the additional costs of hiring new consultants, a rise in 3rd party consultants and increased investment in the off-shoring capability. This has been offset by an improvement in pricing power although EPS forecasts have fallen fractionally to reflect a combination of the overall margin effect and the recent share placing.

Outlook

The prospects for organic expansion remain positive and look well set to continue out-stripping growth in the overall IT Services market. The blue-chip client base (36 of FTSE-100 companies and half of the DAX 30) enhances the quality of earnings as does the increasing proportion of long-term contracts.

Valuation: Look beyond '08

Although a rise in the 2008 tax charge limits EPS progress in the next two years, a normalised P/E of around 12x is not demanding given the underlying growth prospects. Our DCF analysis supports a base case valuation of c.280p and the commencement of dividends also offers some yield support — the higher payment in 2007 includes the well flagged deferral, for technical reasons, of the '06 distribution.

Price 251.5p
Market Cap £46.9m

Share price graph



Share details

Code SQS
Listing AIM
Sector Software & IT Services
Shares in issue 18.7m

Price

52 week High 263.5p Low 181.0p

Balance Sheet as 31 December 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	50%	49%	51%
P/CF	11.1	4.6	4.2
EV/Sales	0.4	0.3	0.4
ROE	17%	14%	15%

Geography based on revenues

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

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Exhibit 1: Financials

*Note: Forecast net interest represents an estimate of the actual amount and excludes the IFRS impact of theoretical interest on deferred payments.

	€'000s	2005	2006	2007e	2008e	2009e
Year-end 31st December						
PROFIT & LOSS						
Revenue		54,737	78,933	104,500	115,000	125,500
Cost of Sales		(35,563)	(51,997)	(68,970)	(75,900)	(82,830)
Gross Profit		19,174	26,936	35,530	39,100	42,670
EBITDA		6,847	8,506	10,823	13,044	13,979
Operating Profit (before GW and except.)		4,486	5,734	8,023	10,244	11,179
Goodwill Amortisation		0	0	0	0	0
Exceptionals		0	(276)	0	0	0
Other		0	0	0	0	0
Operating Profit		4,486	5,458	8,023	10,244	11,179
Net Interest		(773)	(390)	(150)	(150)	(150)
Profit Before Tax (norm)		3,713	5,344	7,873	10,094	11,029
Profit Before Tax (IFRS)		3,713	5,068	7,873	10,094	11,029
Tax		(1,319)	(383)	(1,968)	(3,028)	(3,309)
Profit After Tax (norm)		3,475	4,573	5,905	7,066	7,720
Profit After Tax (IFRS)		2,394	4,685	5,905	7,066	7,720
Average Number of Shares Outstanding (m)		11.7	16.5	19.3	22.4	24.0
EPS - normalised (c)		20.5	27.8	30.6	31.5	32.2
EPS - IFRS (c)		20.5	28.4	30.6	31.5	32.2
Dividend per share (c)		0.0	0.0	15.5	8.9	10.3
Gross Margin (%)		35.0%	34.1%	34.0%	34.0%	34.0%
EBITDA Margin (%)		12.5%	10.8%	10.4%	11.3%	11.1%
Operating Margin (before GW and except.) (%)		8.2%	7.3%	7.7%	8.9%	8.9%
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	28,642	27,426	31,283
Stocks		135	314	600	700	800
Debtors		11,951	23,289	22,000	22,000	22,000
Cash		6,465	2,565	5,642	4,276	7,983
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	43,142	47,426	54,283
CASH FLOW						
Operating Cash Flow		4,106	2,909	8,126	10,444	11,879
Net Interest*		(833)	(492)	(150)	(150)	(150)
Tax		(509)	(841)	(771)	(1,968)	(3,028)
Capex		(2,961)	(3,199)	(3,000)	(3,000)	(3,000)
Acquisitions/disposals		95	(4,080)	(9,000)	(9,000)	0
Financing		14,120	2,755	10,667	7,300	0
Dividends		0	0	0	(2,992)	(1,994)
Net Cash Flow		14,018	(2,948)	5,872	634	3,707
Opening net debt/(cash)		14,300	282	3,230	(2,642)	(3,276)
HP finance leases initiated		0	0	0	0	0
Other		0	0	0	0	(0)
Closing net debt/(cash)		282	3,230	(2,642)	(3,276)	(6,983)

Source: Company accounts/Edison Investment Research

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