THE UK SHAREHOLDERS' ASSOCIATION INVESTIGATES AIM COMPANIES' ANNUAL REPORTS

SQS SOFTWARE QUALITY SYSTEMS AG – No. 95 in Investors Chronicle 'AIM 100' April 2016

Annual Report for year ended 31 December 2015

INTRODUCTION

Software Quality Systems AG (SQS) is an acquisitive German company, quoted on AIM and the Deutsch Bourse Frankfurt, and currently serving mainly European markets. The figures are in Euros but reporting is similar to that for a UK company except for the layout and the provision of more detail in some of the notes. What does SQS do? Unfortunately, as with several other companies we have studied, no simple explanation is given. The nearest approximation appears to be that SQS provides a service to businesses to assist in ensuring the highest quality and efficiency in the design, implementation, operation and functional testing of software and related systems.

Sales for the year were well up at €320.7m (2014 €268.5m), due almost equally to growth and strategic acquisitions. Despite the higher margins achieved by the acquirees, the gross margin fell to 31.5% of sales (33.4%) and the pretax profit to 3.2% (3.8%). Whilst gross margins were slightly down in the main activities, the chief culprit was a significant drop in the sales and gross margin on routine testing, where contracts are short term and price sensitive.

THE BUSINESS

The company serves a wide range of customers from banking, insurance and utilities through to manufacturing; sales have grown from €79m in 2006 to the current €321m. Interestingly, although we are well aware of our own Government's failure to control IT projects, no national bodies appear in the SQS commentary, even as potential customers. The services provided are,

- Managed Services. 47½% of sales, 36½% gross margin. Longer term contracts to provide software test services. 27% growth, year on year, largely organic.
- Specialist Consultancy Services. 11½% of sales, 34% g m. Helping customers at the design and implementation stage or to change systems. 77% growth, largely from acquisitions in the US.
- Regular Testing Services. 31% of sales, 26½% g m. Short term, usually localized services for cost conscious customers. Useful where clients can be moved to a higher margin activity. "3% *managed decline, now stable".*
- Other. 10% of sales, 20% g m. Related activities, not readily classifiable.

The current geographical sales split is Germany 30%, UK 15%, Rest of Europe 38%, USA 12%, Rest of World 5%. There are no direct prior year comparatives, except for Germany which shows a small fall. A major push is being made into the US, with acquisitions showing pro-rata sales of €21.1m (€41.7m annualized) out of the €38.5m total (Note: these figures have been estimated because there is an error in Note 5, table at foot of page 47).

There is no indication given as to how much of the long term sales growth has been achieved from acquisitions but a helpful analysis of Goodwill (Note 10) does suggest that they have been significant. At the yearend Goodwill was €92.5m (€55.8m), with the major items being,

- UK, €31.6m goodwill from prior years against 2015 sales of €48m.
- Management Consulting, €9.1 goodwill (prior years). Presumably this was in Germany and is the basis for the Specialist Consultancy activity with sales of €37m.
- India, €16.7m goodwill (increased in 2014 and 2015). India is being developed as a platform for serving several geographical markets and (Note 4) had sales, apportioned to these other markets, of €34m.
- USA, €30.0m goodwill (2015) out of a purchase price in shares, cash and incentive payments of about €60m. This was entirely for two acquisitions which contributed pro rata sales of €21m (€42m annualized) and €1m

profit before tax . Not cheap, but the 4.8% pretax margin compares favourably with 2.9% for SQS excluding these acquisitions and a small one in Italy.

THE REPORT

At 78 pages (incl. covers) the document is an acceptable length and is clearly laid out, with the caveat that the use of a light grey type face makes the text unnecessarily difficult to read. The English translation is good, although proof reading is not perfect, with several German words appearing randomly in the notes, several errors in line headings and one significant error to the figures (Note 5, see above). Since we are in Germany, the Chief Executive Officer's report takes pride of place and is concise (4 pages) whilst largely avoiding 'buzz' words and phrases. This is followed by a commendably brief report from the Supervisory Board (2pp, equivalent to a UK Chairman's Report but much briefer) and then the Group Management Report (8pp, UK:Financial plus operational details and Risk Assessment). This approach works well because it gives the necessary information, relegates the rest to the notes, and avoids the duplication which often occurs between a UK Chairman and CEO.

The reporting section opens with a page of Key Data and then the Mission Statement. Unfortunately, this Statement is the only part of the whole report which falls head first into the marketing trap of spouting meaningless guff. Your reviewer would be more than happy for all Mission Statements to be binned for ever and replaced by a simple statement of Strategic Objectives.

There is a clear list of contents, a simple Corporate Governance chart and useful diagrams illustrating customer and market breakdowns. It has taken only 27 succinct pages to reach the Financial Statements and Notes. Contributing to this welcome brevity is the fact that the Notes have been expanded to include, firstly, Remuneration and, secondly, some of the information which UK directors feel is useful to pad out their personal reports. The Notes themselves give more detail than for UK companies on such items as Receivables, Payables/other liabilities and Deferred Tax; all this should be very helpful to the potential investor wanting to do some detective work.

THE NUMBERS

The balance sheet shows Equity of €119.3m, including intangibles of €119.1 (goodwill €92.5m, other €26.6m), giving plenty of fuel to the debate as to whether or what value intangibles give to shareholders. Tangible fixed assets are €15.8m, with other assets less liabilities giving a net liability of €15.6m. Borrowings together with deferred payment consideration included in liabilities are €79.0m. The layout of the balance sheet tends to present these figures in a more flattering light but the evidence is all provided by the notes.

Cash flow, at €16.3m after financing costs but before the outlay on acquisitions, is better than might be expected from the modest pre tax profit figure of €10.3m because control of working capital is good. Amortization and depreciation is €15.8m (including €10.1m on development costs v €13.0m capitalised in the year).

Return on equity is a modest 8.6% which, allied to the already high level of intangibles, suggests to your reviewer that a period of consolidation and margin improvement is required.

SQS operates in many different currencies, so risk management and hedging is a key factor, particularly for a company with fairly slender margins. Disclosure in the Group Management Report and in the Notes is detailed, with the £ being the biggest risk factor at €100k for each percent movement, a fall in the £ being negative.

DIRECTORS & EMPLOYEES

Remuneration and Pensions are covered satisfactorily in the notes and reporting is fairly simple as there is only one share option scheme, recently introduced, and pensions are defined contribution except for a small scheme in Switzerland which has a deficit of €5.9m

There are three male members of the Executive Board, the CEO, Finance Officer and Operations Officer. Their total remuneration was €1.3m, with minimal shares owned outright but they do have a total of 1.3m options, equal to 4% of the issued shares.

There are six members of the Supervisory Board, one being female. Earnings are not disclosed and we are not given any biographies. One director holds 12% of the issued shares.

The average number of employees was 4,411 (now over 4,600) with average emoluments of €47.8k, which appears low for the type of business probably because of the Indian operation. Key employees hold 1.1m options.

CONCLUSION

SQS is a professionally run international business with a small share of a growing market. Profit margins are low but the results being achieved by recent acquisitions suggest that there is useful scope for improvement. The presentation of the report makes it much easier to read than its UK counterparts and the high level of disclosure – happily confined to the notes – would satisfy most analysts. Would that all AIM companies could be persuaded to copy SQS.

HPB 01/07/2016