SThree PLC

STEM | FTSE 250 | Support Services | 425p | £566m

FY23 Final Results – peer group leading performance

1 Year Chart

SThree PLC is a research client of H2 Radnor Ltd.

MiFID II – this research is deemed to be a minor, non-monetary benefit.

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Robert Plant

rplant@h2radnor.com

+44 (0) 203 897 1846

In FY23, SThree's net fees (constant currency) declined by 4%, and although the trading environment remains tough, we note that across the last four quarters it delivered a better net fee performance than the average of the quoted UK recruitment peers (Hays, Page and Robert Walters), reflecting its more defensive profile, especially its focus on Contract (82% of net fees) and STEM sectors.

The Technology Improvement Plan (TIP) remains on track and budget with the first iteration now live across the US business, with the next phase of sequential implementation planned across Germany, UK and the Netherlands. We see the TIP as an opportunity to further increase the Group's already sector-leading conversion margin.

We have reduced both our FY24 and FY25 EPS forecasts by 3% to account for the fact that trading since the start of this year has been somewhat subdued, as we have also heard from other recruitment companies.

- **Net Fees**: FY23 net fees (constant currency) were down 4% YoY, with a sharp contrast between Contract (82% of net fees) which saw a rise of 1% and Perm (18% of net fees) which was down 22%.
- **Operating profit** reduced by 5% (constant currency), from £77.6m in FY22 to £76.4m in FY23, against a strong comparator with FY22 being a record year. The decline in net fees was partly offset by a 2% reduction in headcount. SThree's operating profit conversion ratio (OPCR) rose from 18.0% in FY22 to 18.2% in FY23. The OPCR would have been 19.2% without the TIP spending. The OPCR of 18.2% was better than the 17.0% we had forecast mainly due to timing issues, especially on the phased spending on the TIP. The TIP is on track and budget with the first iteration now live across the US business and will next be rolled out to Germany.
- **Net cash** rose from £65.4m at the end of FY22 to £83.2m at the end of FY23, partly due to the natural release of working capital as net fee momentum moderates, proving a counter-cyclical stabiliser. For us, a building net cash position provides interesting options for acquisitions or capital returns and the Group's capital allocation policy was refreshed at the start of 2024 with the deployment of capital prioritised in order of 1) organic growth 2) business improvement 3) acquisitions and 4) capital return to shareholders.

Nov, £m	Net Fees	PBT adj	EPS (p)	Div (p)	Net Cash	PE x	Yield %
FY 2022A	430.6	77.0	39.9	16.0	65.4	10.7	3.8
FY 2023A	418.8	77.9	41.5	16.6	83.2	10.2	3.9
FY 2024E	*418.8*	*72.2*	*37.6*	*15.0*	*95.3*	*11.3*	*3.5*
FY 2025E	*441.6*	*84.5*	*43.3*	*17.3*	*111.6*	*9.8*	*4.1*
FY 2026E	*465.7*	*92.3*	*46.7*	*18.7*	*121.3*	*9.1*	*4.4*

Source: h2Radnor

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Main points of interest from the results and webinar

- **Net fees** (constant currency) declined by 4%, from £431m in FY22 to £419m in FY23, against a record prior-year comparator, and that it had a better net fee performance than the average of the quoted UK recruitment peers across the last four quarters. The 4% decline was all volume related whereas contact length increased, fees rose, and the salaries of jobs placed were up by 4%.

- We believe that the Group's outperformance of peers, against a tough macro backdrop, mainly reflects its more defensive profile with Contract comprising 82% of net fees (up from 74% in FY19), which saw net fees rise 1%, compared to Perm, accounting for only 18% of net fees, which reported a 22% decline in net fees. In contrast, the other three quoted UK recruitment companies have, on average, a 39/61% net fee exposure to Contract vs Perm. Plus, we think that the Group benefits structurally from the growing proportion of roles which require STEM skills.

- The contractor order book of £184 million, whilst down 3% YoY, from £186m, versus a record prior year, represents sector-leading visibility with the equivalent of around four months' net fees, providing a robust platform for the year ahead.

- **Current trading**; In the results statement, SThree mentioned "contract extensions remain strong whilst new business activity continues to be subdued for longer than expected". The Group reported Q423 net fees (September to November) in December and there was a question on the webinar about trading since the end of November, in reply management said that positively they were seeing very strong extensions in Contract, showing how much demand there is, but on the Perm side although clients have budget available they are currently careful about spending, caveated that December and January are always difficult months to read. We note that both Hays and Page mentioned a weaker calendar Q4 trading, and outlook, when they issued trading statements in January. Given the relatively subdued start to the year, for SThree we have reduced by our FY24 and FY25 EPS forecasts by 3%. We detail our estimate revisions in Figure 1 below.

- **Operating profit** reduced by 5% (constant currency), from £77.6m in FY22 to £76.4m in FY23, against a strong comparator with FY22 being a record year. The decline in net fees was partly offset by a 2% reduction in headcount. SThree's operating profit of £76.4m, was 7% better than our forecast of £71.2m, as the OPCR rose from 18.0% in FY22 to 18.2% in FY23, whereas we had predicted a decline to 17.0% due mainly to our expectation of costs associated with the TIP. We note that excluding investment in the TIP the OPCR would have been 19.2% in FY23. The FY23 OPCR was ahead of our expectations largely due to timing of recognition of TIP expenses, lower than expected final bonus and commission payments, and the release of some specific bad debt provisions following successful collections since the year-end.

- We see the main factors which drove an improvement in the FY23 OPCR as timing-related, noting the comment that "in the very short term we expect margins to temper in FY24 before improving in FY25". We forecast OPCR declining to 17.0% in FY24, but then rising to 18.9% in FY25 and 19.5% in FY26 as the TIP spending declines and its benefits materialise.

Figure 1: h2Radnor estimate revisions

November year end £m	FY'23A	Previous FY'24E	Previous FY'25E	New FY'24E	New FY'25E	Revision FY'24E	Revision FY'25E
Gross Revenue	1,663.2	1,612.2	1,699.8	1,666.3	1,754.5	3%	3%
Net fees							
DACH	148.9	148.7	156.4	144.7	152.3	(3%)	(3%)
Netherlands	82.1	86.3	91.4	84.9	89.9	(2%)	(2%)
Rest of Europe	70.4	71.0	73.6	71.2	73.7	0%	0%
USA	96.4	96.3	102.8	96.5	102.9	0%	0%
Middle East, Asia	20.9	21.8	22.8	21.7	22.8	(0%)	(0%)
Total Net Fees	**418.8**	**424.0**	**447.0**	**418.8**	**441.6**	**(1%)**	**(1%)**
EBITA	76.4	73.4	85.8	71.2	83.5	(3%)	(3%)
Margin (%)	*18.2%*	*17.3%*	*19.2%*	*17.0%*	*18.9%*		
Adj. PBT	**77.9**	**74.4**	**86.8**	**72.2**	**84.5**	**(3%)**	**(3%)**
Adj. EPS (p)	41.5	38.7	44.5	37.6	43.3	(3%)	(3%)
DPS (p)	16.6	15.5	17.8	15.0	17.3	(3%)	(3%)
Net cash (debt)	83.2	97.6	114.5	96.5	112.8	(1%)	(1%)

Source: h2Radnor

- **Productivity reduced by 2%,** with the impact of lower net fees partly offset by a 2% decline in average headcount for the year. On hiring, management added, during Q&A, that in the context of the 2% headcount reduction SThree had anticipated well last year the macro trends, that it is now well invested if markets improve as expected in H2 and that it has no plans to reduce headcount further.

- **The TIP** remains on track and budget with the first iteration now live across the US business, with the next phase of sequential implementation planed for Germany, UK and the Netherlands. During the Q&A section of the webinar, management were asked if they would delay the roll-out of the TIP if markets remain uncertain, to which they said that the TIP is a medium/long term programme which is not going to be deferred. We also think that SThree is well placed to invest in the TIP given it has net cash of £83m.

- There was an interesting section of the webinar on the TIP, setting out many of its benefits. For us, some of the positives include; end-to-end integration, automation of manual processes providing operational leverage and scalability, enabling sales consultants to accelerate time to productivity, potential impacts on churn, creating barriers to entry/exit and a platform for M&A. We believe that the TIP has the potential to materially increase SThree's already sector leading conversion margin.

- **The final dividend** proposed of 11.6p per share (FY22: 11.0p per share), resulted in a 4% rise in the full year dividend from 16.0p in FY22 to 16.6p in FY23, in line with the dividend cover target range between 2.5x and 3.0x.

- **Strong balance sheet**; SThree's net cash rose from £65.4m at the end of FY22 to £83.2m at the end of FY23, benefitting partly from the natural release of working capital as net fee momentum moderates. The investment in working capital is a key feature of SThree's economic model and represents a source of material balance sheet strength during periods of net fee softness. This anti-cyclical nature of SThree's cash generation is another important point of differentiation between SThree and the broader recruitment peer group.

- For us, a building net cash position provides interesting options for acquisitions or capital returns. At the results, management set out the Group's capital allocation policy which was refreshed at the start of 2024 with the deployment of capital prioritised in order of;

  1) **Organic growth**; Investing in our people, ensuring sufficient working capital on hand to fund growth of the contractor order book while developing new business opportunities.

  2) **Business improvement**; Digitalising our business, putting in place the technology and tools that are key to driving both scale and higher margins.

  3) **Acquisitions**; Strict inorganic growth discipline, with a focus on complementary and value enhancing acquisitions.

  4) **Capital return to shareholders**; If all organic and inorganic opportunities within an appropriate time horizon have been considered, return excess cash either through special dividend or share buybacks.

SThree's continuing relative outperformance not reflected in valuation

In what are undoubtedly tricky trading conditions, the dual aspect of SThree's business model continues to stand out relative to UK listed peers. SThree's net fee generation is a function of two elements:

→ **Contract extensions and renewals** have proven resilient with performance here at least in-line, if not marginally better than initial expectations. We note the material increase in average contract lengths and also continuing wage inflation, which all point to a positive demand / supply imbalance. SThree has also seen overall pricing holding up well, further supports this underlying demand dynamic.

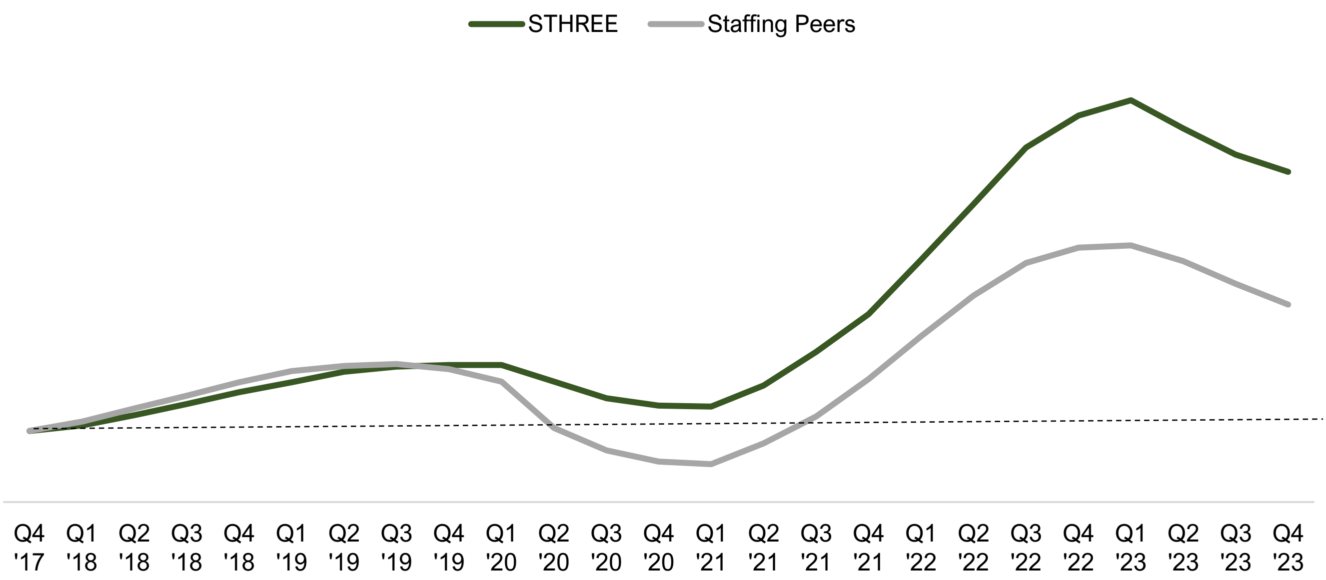
→ **New business** has been more variable, a point that the company has been explicit around throughout FY23. Despite some green shoots being seen at the time of the Q3 trading update, these have not fully manifested into a concerted recovery. New business trends remain volatile. Lead macro indicators, despite improving sentiment, are yet to show any meaningful improvement.

We have highlighted in previous research notes that this interplay between the existing contractor base and the new business pipeline is a feature of SThree that marks it out from UK listed peers; none of whom enjoy the same weighting towards Contract and the net fee duration and visibility that the SThree flavour of Contract enjoys.

The key point here is not that SThree is immune from cyclical pressures that affect all recruitment businesses; but that the SThree net fee and margin curves should be flatter and significantly less volatile than others. The extent of estimate downgrades across the peer group bear this out.

We have already seen this play out through the pandemic (see Fig 2 below) and we can see a similar shape take form when we look at how one year forecast estimates have evolved across the peer group over the course of the last year (Fig 3 and 4).

Figure 2: SThree vs Peers – Quarterly LFL net fee YoY growth indexed back to 100 in Q4 2017



Source: Radnor

Below in Figure 2 we show the evolution of one year forecast consensus estimates for PBT for SThree and the peer group, rebased to SThree, over the last 12 months. In Figure 3 we show the evolution of consensus FY1 EBIT margins for each member of the peer group.

Figure 3: SThree vs Peers – Consensus PBT

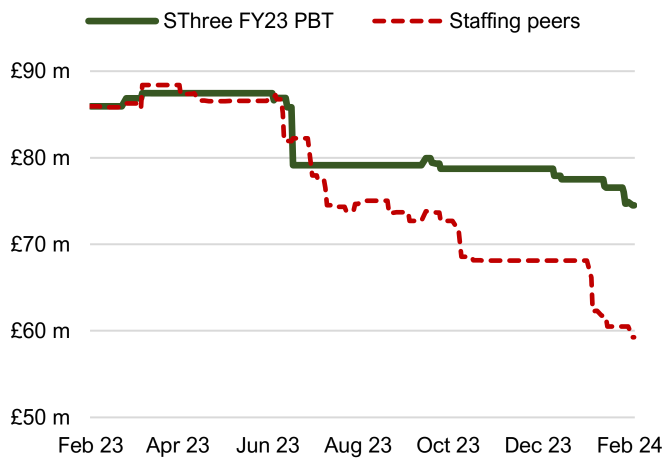
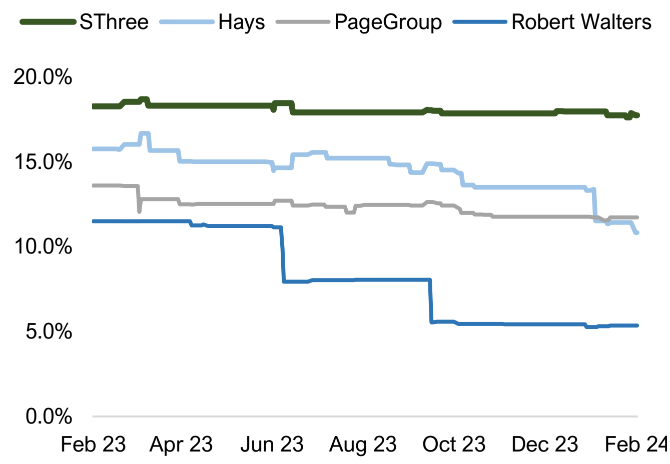


Figure 4: SThree vs Peers – EBIT margin



Source: h2Radnor, FactSet

- Over the last year, the peer group has seen FY24 PBT consensus expectations downgraded in aggregate by **-31%**.
- By contrast, SThree has seen FY24 PBT consensus decline by **-13%.**
- SThree's margin expectations are taken **after** the cost of the Technology Improvement Programme, which has been guided between £6m - £8m of P&L expense in FY24E. On an underlying, pre-investment basis, we estimate FY24 EBIT margins would be c**19.0%** versus our current expectation of 17.3%, which is still some way clear of the peer group**.**

Despite this clear net fee and margin outperformance, the valuation gap between SThree and its peers remains material and has widened back out in recent months as extensive peer group downgrades have not fed through into share price performance.

In Figure 5 & 6 below, we show the evolution of the one-year prospective PE multiple for both SThree and the UK listed staffing Peer group (Hays, Page, Robert Walters).

Figure 5: 1 Year prospective PE multiple

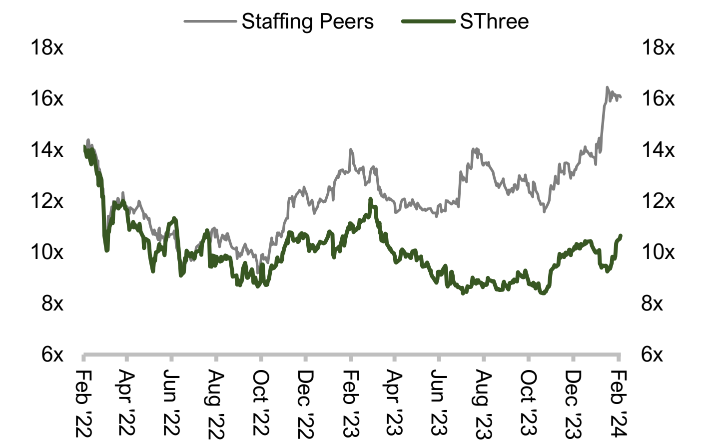
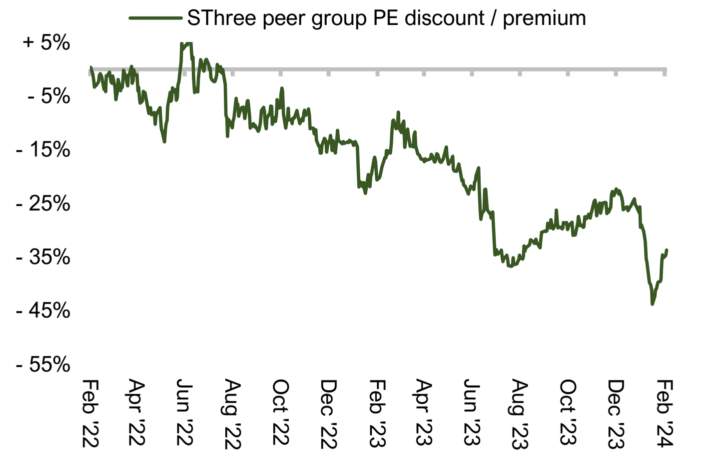


Figure 6: SThree PE discount / premium



Source: h2Radnor, FactSet

SThree PLC

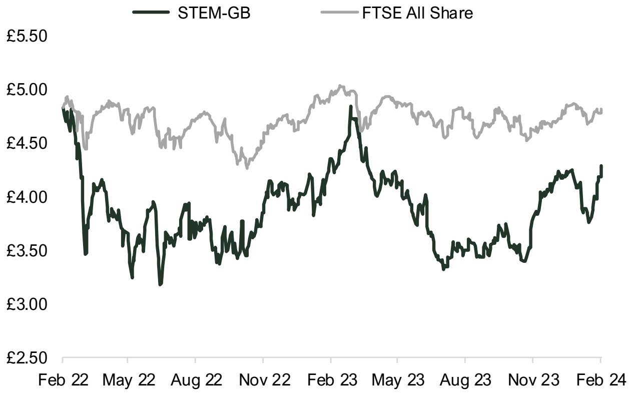
Robert Plant
+44 203 897 1846
rplant@h2radnor.com

Price (p): **425 p**
Market Cap: 566 m
EV: 483 m

PROFIT & LOSS

Year to 31 November, £m	2022	2023	2024E	2025E	2026E
Group Sales	**1,639.4**	**1,663.2**	**1,666.3**	**1,754.5**	**1,847.6**
DACH	*148.9*	*148.9*	*144.7*	*152.3*	*160.3*
Netherlands	*75.7*	*82.1*	*84.9*	*89.9*	*95.2*
Rest of Europe	*73.1*	*70.4*	*71.2*	*73.7*	*76.4*
USA	*111.5*	*96.4*	*96.5*	*102.9*	*109.9*
ME & Asia	*21.4*	*20.9*	*21.7*	*22.8*	*23.9*
Group Net Fees	**430.6**	**418.8**	**418.8**	**441.6**	**465.7**
Op. Exp.	(334.2)	(326.5)	(331.7)	(341.4)	(357.2)
EBITDA	**96.5**	**92.3**	**87.1**	**100.2**	**108.5**
Depr & Amort (incl lease)	(18.9)	(15.9)	(15.9)	(16.8)	(17.7)
EBITA - Adjusted	**77.6**	**76.4**	**71.2**	**83.5**	**90.8**
EBITA conversion %	**18.0%**	**18.2%**	**17.0%**	**18.9%**	**19.5%**
Associates & JV's	-	-	-	-	-
Net Bank Interest	(0.5)	1.6	1.0	1.0	1.5
PBT - Adjusted	**77.0**	**77.9**	**72.2**	**84.5**	**92.3**
Non Operating Items	-	-	-	-	-
Other Financial Items	-	-	-	-	-
PBT - IFRS	**77.0**	**77.9**	**72.2**	**84.5**	**92.3**
Tax - Adjusted	(22.8)	(21.9)	(20.9)	(24.9)	(27.7)
Tax rate - Adjusted	*29.6%*	*28.1%*	*29.0%*	*29.5%*	*30.0%*
Minority interests	-	-	-	-	-
No. shares m, diluted	135.9	135.0	136.5	137.5	138.5
Adj EPS (p), diluted	**39.9**	**41.5**	**37.6**	**43.3**	**46.7**
Total DPS (p)	16.0	16.6	15.0	17.3	18.7

PRICE CHART - 2 YEAR ABSOLUTE vs FTSE ALL SHARE



Source: FactSet

SHAREHOLDERS

	% of ord. Share capital
Kempen Cap Mgmt	11.6%
JPMorgan AM	6.4%
JO Hambro	5.7%
Littlejohn	5.1%
Allianz	4.9%
BlackRock	4.8%
Montanaro	3.7%
	42.2%

CASH FLOW

Year to 31 November, £m	2022	2023	2024E	2025E	2026E
EBITDA	96.5	92.3	87.1	100.2	108.5
Working Capital	(38.6)	(4.0)	(4.9)	(14.1)	(24.7)
Exceptionals / Other	6.5	5.0	(0.6)	(0.6)	(0.1)
Gross Op Cashflow	**64.4**	**93.3**	**81.7**	**85.6**	**83.8**
Cash Tax	(18.9)	(19.5)	(18.8)	(22.4)	(24.9)
Cash Intererest	(0.7)	(0.7)	1.0	1.0	1.5
Net Op Cashflow	**44.8**	**73.1**	**63.9**	**64.1**	**60.3**
Capex	(3.7)	(8.2)	(5.9)	(2.6)	(1.9)
Lease	(13.7)	(14.3)	(13.4)	(14.1)	(14.9)
Free Cashflow	**27.4**	**50.6**	**44.6**	**47.3**	**43.6**
Dividends	(14.7)	(27.4)	(22.5)	(21.6)	(24.5)
Acquisitions & Inv.	-	-	-	-	-
Lease / EBT	(9.4)	(7.6)	(8.8)	(9.4)	(9.4)
Net Cashflow	**3.4**	**15.7**	**13.3**	**16.4**	**9.7**
Net Cash (Debt)	**65.4**	**83.2**	**96.5**	**112.8**	**122.5**

Announcements

Date	Event
30 January 2024	FY results
14 December 2023	Q4 update
19 September 2023	Q3 update
25 July 2023	H1 results
20 June 2023	Q2 update
21 March 2023	Q1 update

RATIOS

	2022	2023	2024E	2025E	2026E
RoE	27.0%	25.1%	21.0%	21.7%	21.0%
RoCE	57.4%	54.7%	48.2%	51.7%	49.1%
Asset Turnover (x)	0.1x	0.1x	0.1x	0.1x	0.1x
NWC % Revenue	37.1%	34.6%	37.3%	38.7%	40.6%
Op Cash % EBITA	83.0%	122.2%	114.7%	102.5%	92.2%
Net Debt / EBITDA	-0.7x	-0.9x	-1.1x	-1.1x	-1.1x

BALANCE SHEET

Year to 31 November, £m	2022	2023	2024E	2025E	2026E
Intangibles	0.8	7.1	0.8	0.8	0.8
P,P+E	35.2	31.1	34.7	34.9	34.1
Tax Asset & Other	4.6	5.8	5.8	5.8	5.8
Total Fixed Assets	**40.7**	**44.0**	**47.1**	**46.9**	**45.7**
Current Assets	363.9	345.1	370.9	407.1	455.1
Current Liabilities	243.6	229.5	250.5	272.6	295.9
Net Current Assets	**120.3**	**115.6**	**120.4**	**134.6**	**159.2**
Long Term Liabilities	14.8	24.1	27.2	27.0	25.8
Net Cash (Debt)	65.4	83.2	96.5	112.8	122.5
Net Assets	**200.4**	**222.9**	**244.1**	**274.4**	**307.5**

VALUATION

Fiscal	2022	2023	2024E	2025E	2026E
P/E	10.7x	10.2x	11.3x	9.8x	9.1x
EV/EBITDA	5.0x	5.2x	5.5x	4.8x	4.5x
Div Yield	3.8%	3.9%	3.5%	4.1%	4.4%
FCF Yield	5.7%	10.5%	9.2%	9.8%	9.0%

YoY growth	2022	2023	2024E	2025E	2026E
Net Fees	21.1%	-2.7%	0.0%	5.4%	5.5%
EPS	29.5%	4.1%	-9.5%	15.3%	7.7%
DPS	45.5%	3.8%	-9.5%	15.3%	7.7%

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H2 Radnor Ltd
68 King William Street
London
EC4N 7HR

www.h2radnor.com

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