SThree PLC

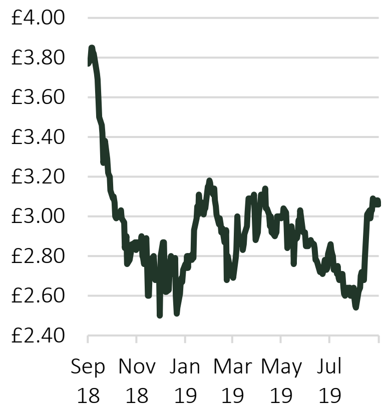
STHR | Small Cap | Support Services |306p |£402m

Q3 trading update – Is the message finally landing?

The Q3 trading update was consistent with previous updates and results. SThree continues to perform well in its key growth markets and niche verticals. Net fees were up 6% despite tough comps. As in previous commentaries, management were right to flag macro concerns even though the business has yet to show any signs of material weakness. The key message we took away was that overall expectations for the full year remain unchanged. The subsequent SThree share price outperformance suggests the market may be listening.

The Capital Markets Day will be on 21st November. This will provide new CEO, Mark Dorman, the opportunity to outline clearly the direction of travel. We also see the CMD giving a deeper dive into the clear structural growth opportunities and SThree's less visible assets. We recently spent time at the Glasgow Centre of Excellence and came away seeing Glasgow as far more impactful and front foot than a pure cost cutting exercise. Critically, we believe SThree has a powerful case to make around the fundamental economics of its business model and how this differentiates SThree from its more transactional peers.

1 Year Chart



SThree PLC is a research client of Radnor Capital Partners Ltd.

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

30th September 2019

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- **Q3 update key highlights:** Following this update we are leaving our estimates unchanged. Overall net fees were up 6% yoy (adjusted for one less working day in the quarter and one extra European holiday), with Contract fees up 7% and Perm down 5%. All the markets outside the UK grew (DACH +8%, Japan +8% and USA +5%). This yoy growth was delivered against a tough set of Q3 2018 comps; especially in Europe).

- **Relative attractions:** Whilst we await the latest trading news-flow from peers; it is worth recapping what the data to date has been telling us. In terms of raw net fees growth, SThree is performing well relative to peers. We have also seen continued margin expansion; cash generation and dividend growth.

- **Structural Opportunities and Hidden Assets:** We believe SThree is well positioned to benefit from significant structural growth opportunities (a combination of geography and niche industry focus) that leave it well positioned to face typical late cycle challenges. However, there is more to SThree than the cycle. SThree has been building a global platform that can deliver improving returns from a position of real competitive strength. More than any of its peers; SThree is as much an invested capital story as it is transactional and the investment made in building the Contract business reflects this. Not only does the SThree balance sheet represent a store of reversionary Contract value; it is the key "moat" providing the platform for future returns.

- **Valuation:** Based on FactSet consensus the SThree discount to the peer group has continued to narrow to 23% (-37% at its weakest). We continue to believe SThree will outperform its Perm heavy peers with current data points supporting this view.

YE – November	Net Fees, £m	PBT adj, £m	EPS (p)	Div (p)	Net Cash, £m	PER x	Yield %
FY 2017A	287.7	44.5	24.7	14.0	5.6	12.3	4.6
FY 2018A	321.1	53.3	29.6	14.5	-4.1	10.3	4.7
FY 2019E	*344.0*	*58.5*	*32.3*	*15.3*	*7.1*	*9.5*	*5.0*
FY 2020E	*362.1*	*63.2*	*34.5*	*15.8*	*19.0*	*8.9*	*5.2*
FY 2020E	*379.1*	*67.2*	*36.9*	*16.1*	*40.9*	*8.4*	*5.3*

Source: Radnor Capital Partners

Q3 Trading Update

- Total Q3 net fees of £87.8m (**+6%** yoy adjusted for two fewer working days, +4% on an unadjusted basis);
  - → Contract net fees **+7%** to £66.0m
  - → Perm net fees **-5%** to £21.8m
- By region: DACH net fees **+8%**, USA **+5%**, Japan **+14%** and UK&I **-7%**
- By industry: Technology net fees **+8%**, Energy **+8%**, Engineering **+6%**, Life Sciences **+2%**, and Banking & Finance **-12%**
- Group period-end sales headcount was **+8%** yoy (**+10%** in Contract)
- Net debt at 31st August was £12m, a significant improvement on the £24m in Q3 2018.

As a reminder, on a constant currency basis, group net fees increased by 9% in H1 (+10% on a reported basis) to £163.0m (HY 2018: £148.4m).

Overall, Q3 did see a deceleration from the net fees growth reported in H1; partly due to very tough comps (eg; European net fees growth in Q3 2018 was itself up 24% on Q3 2017) but also a macro led softening in the UK and some European markets.

Europe (57% of group net fees)

Although SThree's performance in Germany was good in Q3 (+8% yoy), this was lower than the 15% growth reported at the half year. The mood music in Germany is still surprisingly solid but is clearly no longer as "frothy" as it has been. This can best be evidenced by the split between Contract (Q3 2019: +12% yoy), which continued to grow well, and Perm, which was flat in Q3 2019 compared to the prior year.

USA (23% of group net fees)

The USA was the biggest contributor to Contract net fees growth (Q3 2019: +16% yoy) as SThree continues to make progress in the largest global recruitment market (as well as the most fragmented). However, the US Perm business did not fare so well (Q3 2019: -20% yoy) as the effects of the 2018 restructuring of the US Perm business continue to flow through.

UK & Ireland (14% of group net fees)

UK&Ireland has been most heavily impacted by macro and sentiment headwinds, with overall net fees declining 7% in Q3 2019. UK&I is also more heavily exposed to the Banking & Finance vertical. Although a specific split has not been provided; it is clear the Contract business in the UK continues to perform better than Perm, which saw a material headcount reduction in 2018. It is worth noting that the headline decline in UK&I overall net fees was lower than the decline reported at the half year. Management emphasis in the UK is on consultant productivity and margin and the group continues to make progress on this front.

Asia Pacific (6% of group net fees)

Although coming off a smaller relative base, APAC grew net fees +14% driven by a very strong performance in the Japanese Perm business (+84% yoy).

Outlook statement

The tone of SThree's outlook commentary has been reassuringly consistent throughout 2019.

'*Whilst we remain cognisant of significant macro market uncertainties, we remain confident that we have the right niche focus, vision and teams to deliver continued growth, and our expectations for the full year remain unchanged.*'

Structural Opportunities and Hidden Assets

Without wanting to steal any thunder from the upcoming Capital Markets Day (21st November), we believe this event will give Mark Dorman, the new CEO, a good opportunity to revisit the key components of the SThree investment case and outline his vision for SThree's future:

- **Structural opportunity in STEM**

  This is perhaps the most clearly articulated and consistent component of SThree's equity story and permeates every aspect of the business model. STEM explains the Contract focus and both the geographical and client spread. We very much doubt Mark would have joined SThree unless he shared this belief in the STEM growth opportunity.

  SThree's basic premise, which we struggle to find fault with, is that STEM disciplines will play an increasingly important role in the global economy over the longer term and that STEM roles will grow faster than the average as a result.

- **Flexible working is a secular trend**

  The most significant change in SThree's business composition since 2012 has been the focus on Contract (ie, shorter term, typically project deployments). In 2012 this was half SThree's business, now it is three quarters. Not only is this recognised as being the most relevent staffing model within the technically demanding industries that SThree specialises in, but the broader flexible working theme is becoming increasingly mainstream across global recruitment markets.

- **Structural opportunity in key markets**

  After 30 years of organic growth, SThree finds itself a fully fledged, global specialist STEM player. Critically, this period of development has made it crystal clear where the geographic growth opportunities reside within the target global industry verticals.

  Here we would not expect the Capital Markets Day to pull any geograhic rabbits out of the hat. For example, SThree is well established in Germany, which remains a relatively immature recruitment market. SThree also has a growing presence in North America, which is not an immature market but is highly fragmented. Both of these are likley to remain central to SThree's growth plans; instead, the strategy and decision making process around the allocation of growth investment is likely to be the focus of attention.

- **Leveraging the benefits of a global platform**

  We recently visited the Glasgow Centre of Excellence and our key take away was the extent this is clearly more than just a cost saving opportunity, although the cost savings are material (£5.5m annualised or £50m capitalised at the current SThree PE multiple).

  We were most taken by the management depth in Glasgow, of which a significant portion has been drawn from businesses outside of recruitment. Historically, SThree has grown both sales and infrastructure organically, with the infrastructure responding to sales rather than anticipating it. Glasgow represents a step away from this model and has been about putting in place a best practice platform with significant latent capacity.

  The "hard" potential Glasgow offers for driving both scale and working capital efficiencies is likely to be material to the SThree investment case. Perhaps the even greater "soft" effect will be the liberation of the sales teams, who historically have been responsible for dealing with service issues as well as generating new revenue. We expect the Capital Markets Day to provide more colour around this significant "hidden" asset.

- **Driving returns**
  We believe the most profound point of differentiation between SThree and its peers is that it looks more like a platform services business than a transactional, spot business.

  We can see this not just from the structure of the balance sheet (where SThree's largest asset is the significant working capital investment it has made in growing the Contract business), but also the emphasis on platform based service delivery and the scale leverage returns this can deliver going forward.

  Put simply, we believe SThree can drive shareholder returns through both the P&L (volume / margin) and the balance sheet (strategic capital allocation / working capital efficiency / platform investments). The more transactional peer group is limited primarily to the P&L as the engine of future returns (ie; turning the handle ever faster). We note that c.23% of SThree's current market cap is represented by the net working capital investment which is all post, not pre, sale (cash due but yet to be collected).

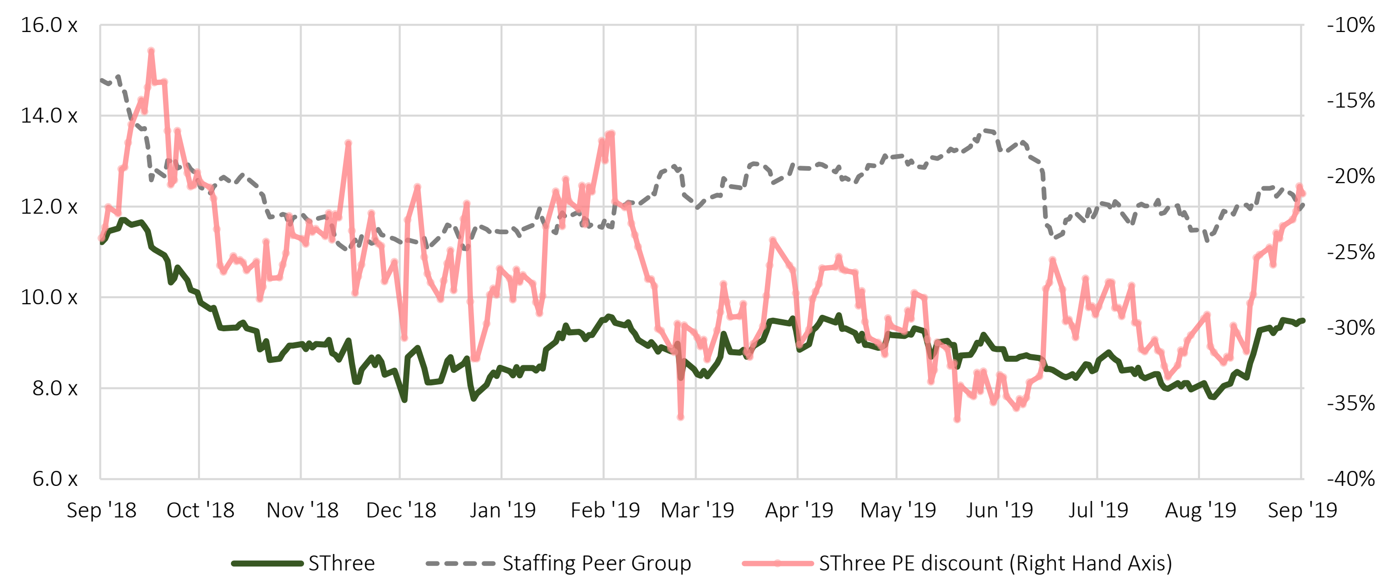
  SThree has a consistent track record on working capital investment and management. Since 2010; Contract gross revenue has compounded at a rate of **14.5%** pa (**£395m** in FY 2010 to **£1.2bn** in FY 2018). Over the same period, the proportion of gross revenue represented by net working capital has compounded at **13%** pa (**3.0%** of Contract gross revenue in FY 2010 compared to **8.0%** of Contract gross revenue in FY 2018).

  The management of the gross revenue and net working capital growth dynamic will be a critical value driver for SThree going forward. We see the Capital Markets Day as being an opportunity for management to show this management process in action and, in particular, to highlight how the Glasgow transition can help release this value.

Peer Group valuation – Discount narrowing

In the chart below, we show SThree's prospective PE relative to the immediate peer group average (Hays, Page & Robert Walters) over the last 12 months.

SThree prospective PE relative to Staffing peer group



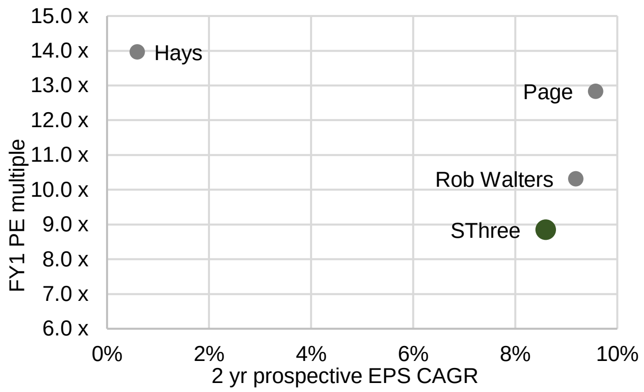
Source: FactSet, Radnor

During the mid-part of the Summer, both SThree and the peer group came under valuation pressure as the market began to discount an increasingly uncertain outlook However, since early August we have seen a stabilisation in the peer group forward PE multiple and a distinct improvement for SThree, where the forward PE is back up to levels last seen in October 2018.

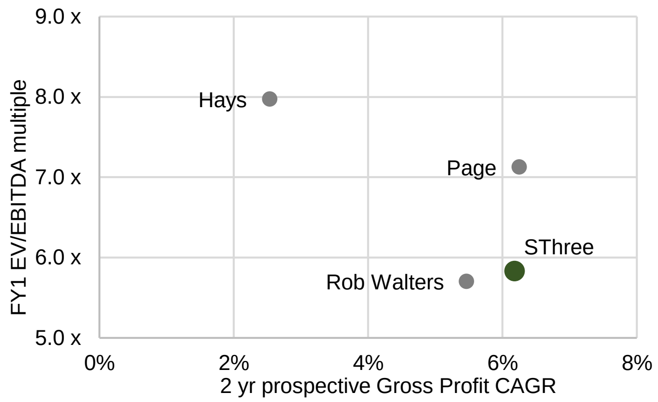
It is too early to tell whether this represents a sustained re-appraisal of SThree relative to the peer group. We suspect not as the absolute level of the peer group discount remains in excess of 20% but it is a notable change in dynamic nonetheless.

We continue to find the disconnect between the consistency of performance and the valuation anomalous. According to FactSet consensus, expectations for SThree's prospective earnings and net fees growth sit well within the peer group bounds. We also note market expectations for SThree dividend growth and cash generation.

UK Staffers - EPS Growth vs PE multiple



UK Staffers – Net Fees Growth vs EV/EBITDA



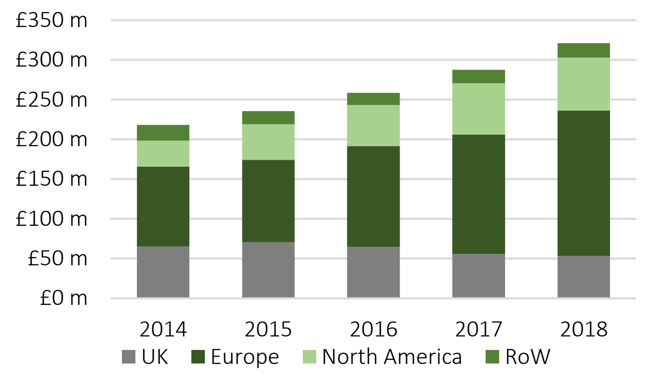
Source: FactSet, Radnor

Key Points – Investment Case

Market Blues	SThree has found itself in the strange position of delivering consistent in-line trading news-flow against a negative sentiment backdrop. The macro data points remain mixed; especially around US and European growth, which has weighed on SThree, despite the trading evidence to date. Staffers are generally perceived as early cycle plays and SThree's differentiated, later cycle business model (greater visibility and quality of earnings) have not fully registered.
Positive Trading	The Q3 update confirms a good top-line +6% YoY. Although not immune to macro headwinds; SThree is likely to enjoy higher levels of visibility compared to its Perm heavy peers, with confidence over FY2019 increasing. SThree has re-affirmed its expectations for the full year.
Non-UK Exposure	**86%** of H1 FY19 net fees generated **outside** of the UK. A key driver of SThree's positive operating performance has been exposure to fast growing and structurally attractive geographies such as **Germany**, **Benelux**, **Japan** and **North America**.
STEM	SThree have a clear ambition of becoming the **Number 1** STEM talent provider in the best STEM markets. STEM (Science, Technology, Engineering and Maths) industries are structurally attractive; **1)** good headline growth, **2)** subject to rapid technology impacts, and **3)** exposed to specific skills shortages. STEM markets also lend themselves to SThree's niche specialist approach where barriers to entry are higher than more generalist staffing markets.
Contract	SThree stands out vs the peer group through its weighting towards Contract (74% of H1 FY19 net fees) relative to Permanent (26% of net fees). This is driven by Contract being the most relevant model for STEM industries. However, Contract offers other positive economic characteristics; **1)** higher lifetime value, **2)** enhanced visibility and quality of earnings, **3)** higher barriers to entry and, **4)** deeper client relationships. The cost is a higher level of up-front working capital investment compared to Permanent, itself a significant barrier to entry.
Investor Focus	We believe investors have focused disproportionately on the performance of SThree's Permanent business in the UK, which is not the key value driver. The fundamental differences in business mix and strategic focus between SThree and its peers, in our view, have not been fully recognised. SThree is also paying the price for defending its dividend since 2012, when the easier choice may have been to reduce. The cash-flow resilience of the Contract model, compared to Permanent, is a key factor here but has yet to be rewarded by the market.
Valuation	Over the last two years, SThree has traded within a 10% - 35% PE discount range to the immediate peer group. The discount has narrowed but remains in excess of 20%, which we question. We believe SThree is less exposed to the headline cyclical risks to be found elsewhere and the current headline prospective PE of 8.9x and dividend yield of 5.5% does not fully recognise SThree's growth and risk characteristics.

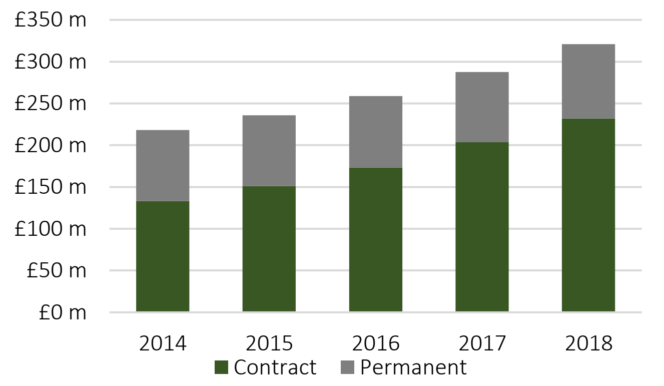
SThree - Key charts

Geographic Net Fees 5 year track record



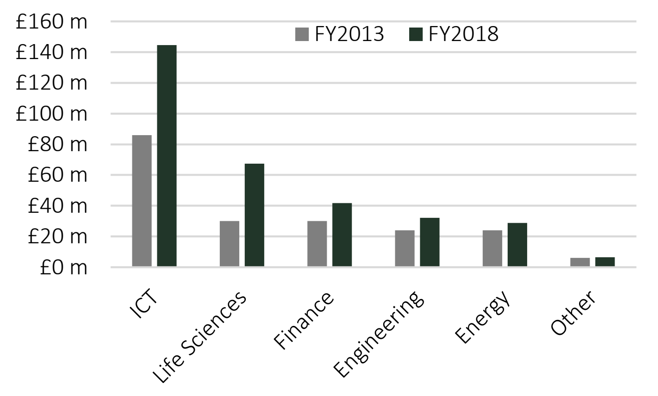
Source: FactSet, Radnor

Contract / Perm Net Fees 5 year track record



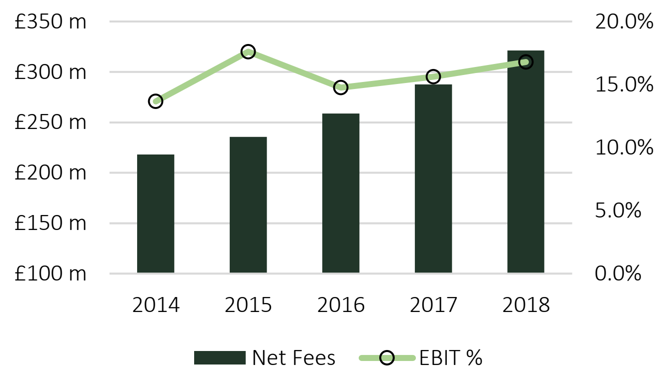
Source: FactSet, Radnor

STEM market Net Fees 2013 vs 2018



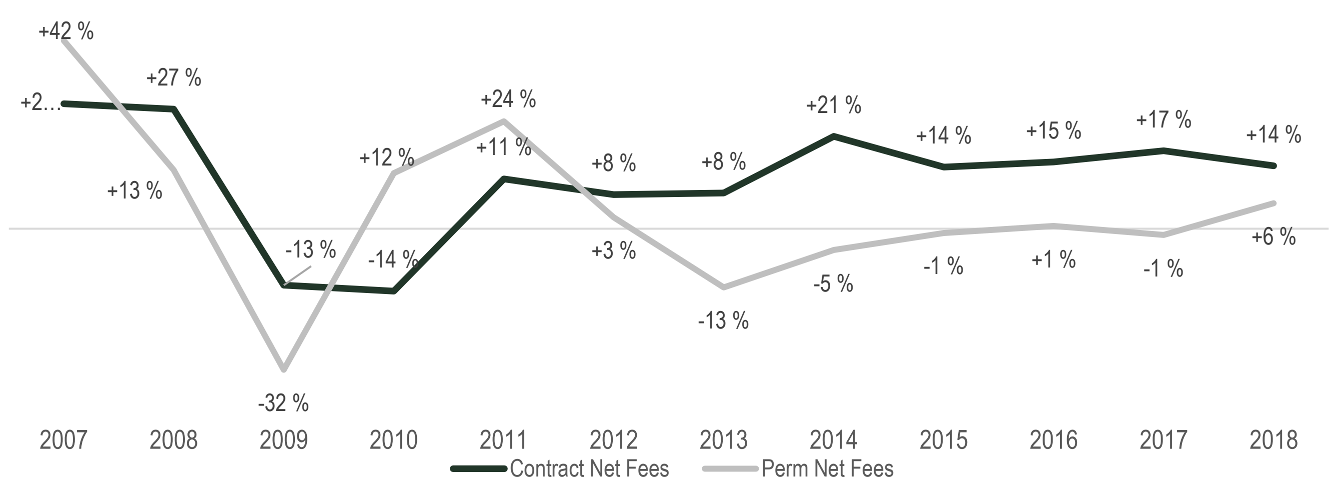
Source: FactSet, Radnor

Net Fees and EBIT margins 5 year track record



Source: FactSet, Radnor

SThree Net Fees growth – Contract vs Permanent



Source: Radnor

Key Estimates

SThree PLC

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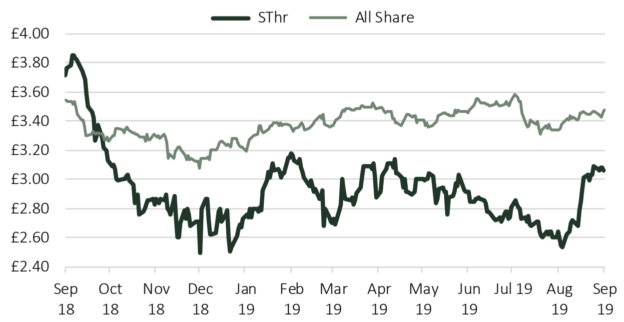
Price (p): **306 p**
Market Cap: 402 m
EV: 406 m

PROFIT & LOSS						
Year to 31 November, £m	**2016**	**2017**	**2018**	**2019E**	**2020E**	**2021E**
Group Sales	**960.0**	**1,114.5**	**1,258.2**	**1,359.6**	**1,436.8**	**1,510.5**
Europe	*126.8*	*150.6*	*183.4*	*203.5*	*217.8*	*230.9*
UK	*64.7*	*55.7*	*53.1*	*49.4*	*49.4*	*49.4*
North America	*51.7*	*64.4*	*66.7*	*72.0*	*74.9*	*77.9*
Asia Pacific	*15.5*	*17.0*	*18.0*	*19.0*	*20.0*	*21.0*
Group Net Fees	**258.7**	**287.7**	**321.1**	**344.0**	**362.1**	**379.1**
Op. Exp.	(214.8)	(237.0)	(261.1)	(278.6)	(292.2)	(305.2)
EBITDA	**43.9**	**50.7**	**60.1**	**65.4**	**69.9**	**73.9**
Depr & Amort	(5.7)	(5.7)	(6.1)	(6.4)	(6.5)	(6.7)
EBITA - Adjusted	**38.2**	**44.9**	**53.9**	**59.0**	**63.4**	**67.2**
Associates & JV's	-	(0.1)	0.1	0.1	0.2	0.3
Net Bank Interest	(0.5)	(0.3)	(0.7)	(0.6)	(0.4)	(0.3)
PBT - Adjusted	**37.7**	**44.5**	**53.3**	**58.5**	**63.2**	**67.2**
Non Operating Items	-	(6.7)	(8.3)	-	-	-
Other Financial Items	-	-	-	-	-	-
PBT - IFRS	**37.7**	**37.8**	**45.0**	**58.5**	**63.2**	**67.2**
Tax - Adjusted	(9.9)	(11.4)	(13.9)	(15.2)	(16.4)	(17.5)
Tax rate - Adjusted	*26.3%*	*25.6%*	*26.0%*	*26.0%*	*26.0%*	*26.0%*
Minority interests	-	-	-	-	-	-
No. shares m, diluted	132.0	132.6	133.1	134.4	135.4	136.4
Adj EPS (p), diluted	**21.1**	**24.9**	**29.6**	**32.2**	**34.5**	**36.5**
Total DPS (p)	14.0	14.0	14.5	15.3	15.8	16.1

PRICE CHART - 1 YEAR ABSOLUTE vs FTSE ALL SHARE



Source: FactSet

SHAREHOLDERS	
	% of ord. Share capital
JO Hambro Cap Mgmt	10.5%
SThree Founders	8.6%
Harris Assoc	5.5%
Allianz Global	5.4%
M&G	4.9%
JPMorgan AM	3.8%
Franklin Templeton	3.5%
	42.2%

CASH FLOW						
Year to 31 November, £m	**2016**	**2017**	**2018**	**2019E**	**2020E**	**2021E**
EBITDA	43.9	50.7	60.1	65.4	69.9	73.9
Working Capital	(4.3)	(16.4)	(25.3)	(16.3)	(17.7)	(8.1)
Provisions / Exceptionals	2.6	5.8	(4.7)	5.0	3.0	3.0
Gross Op Cashflow	**42.2**	**40.1**	**30.1**	**54.1**	**55.1**	**68.9**
Cash Tax	(8.5)	(10.9)	(14.4)	(13.9)	(15.2)	(16.4)
Cash Intereest	(0.5)	(0.3)	(0.5)	(0.4)	(0.4)	(0.4)
Net Op Cashflow	**33.2**	**28.9**	**15.2**	**39.9**	**39.5**	**52.0**
Capex	(6.1)	(5.8)	(5.2)	(6.0)	(6.0)	(6.0)
Free Cashflow	**27.1**	**23.1**	**10.0**	**33.9**	**33.5**	**46.0**
Dividends	(18.0)	(18.0)	(18.0)	(19.3)	(20.6)	(21.4)
Acquisitions & Inv.	(0.7)	(1.2)	-	-	-	-
Other Non Operating	(4.6)	(8.3)	(2.0)	(3.0)	(3.0)	(3.0)
Net Cashflow	**3.8**	**(4.4)**	**(10.1)**	**11.6**	**10.0**	**21.6**
Net Cash (Debt)	**10.0**	**5.6**	**(4.5)**	**7.1**	**17.1**	**38.7**

Announcements	
Date	**Event**
September 2019	Q3 trading update
July 2019	H1 results FY 2019
June 2019	Q2 trading update
March 2019	Q1 trading update
January 2019	Final results FY 2018
December 2018	Q4 trading update

RATIOS					
	2017	**2018**	**2019E**	**2020E**	**2021E**
RoE	41.0%	39.0%	33.4%	29.6%	26.4%
RoCE	59.6%	51.1%	48.2%	45.2%	45.2%
Asset Turnover (x)	0.1x	0.1x	0.1x	0.1x	0.1x
NWC % Revenue	16.5%	28.2%	27.7%	28.5%	23.6%
Op Cash % EBITA	89.2%	55.8%	91.8%	87.0%	102.4%
Net Debt / EBITDA	0.2x	0.1x	-0.1x	0.1x	0.2x

BALANCE SHEET						
Year to 31 November, £m	**2016**	**2017**	**2018**	**2019E**	**2020E**	**2021E**
Intangibles	11.6	11.4	9.6	9.6	9.6	9.6
P,P+E	7.1	6.7	6.9	7.3	7.8	8.5
Tax Asset & Other	3.2	6.0	4.7	4.7	4.7	4.7
Total Fixed Assets	**21.9**	**24.1**	**21.3**	**21.7**	**22.2**	**22.9**
Current Assets	193.9	228.1	288.4	305.9	330.3	347.1
Current Liabilities	(149.2)	(174.9)	(202.3)	(203.6)	(210.2)	(219.0)
Net Current Assets	**44.7**	**53.2**	**86.1**	**102.3**	**120.1**	**128.2**
Long Term Liabilities	(0.9)	(2.2)	(1.6)	(1.6)	(1.6)	(1.6)
Net Cash (Debt)	10.0	5.6	(4.5)	7.1	17.1	38.7
Net Assets	**75.7**	**80.7**	**101.3**	**129.5**	**157.7**	**188.1**

VALUATION					
Fiscal	**2017**	**2018**	**2019E**	**2020E**	**2021E**
P/E	12.3x	10.3x	9.5x	8.9x	8.4x
EV/EBITDA	8.0x	6.8x	6.2x	5.8x	5.5x
Div Yield	4.6%	4.7%	5.0%	5.2%	5.3%
FCF Yield	5.7%	2.5%	8.3%	8.3%	11.3%
Net Fees growth	11.2%	11.6%	7.1%	5.3%	4.7%
EPS growth	18.4%	18.9%	8.6%	7.3%	5.6%
DPS growth	0.0%	3.6%	5.5%	3.3%	1.9%

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