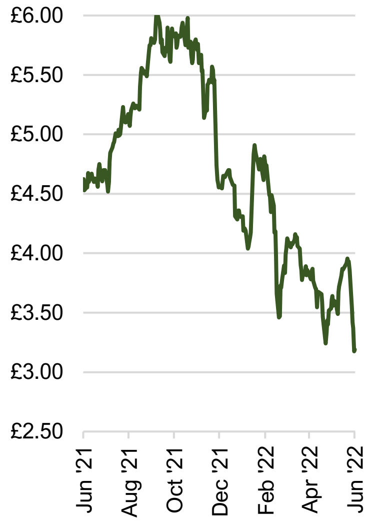
RADNOR CAPITAL PARTNERS

SThree PLC

STEM | Small Cap | Support Services | 319p | £424m

Q2 Trading Update – Further upgrade to expectations

1 Year Chart



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21st June 2022

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SThree's trading performance continues to stand at odds with the share price performance. +25% net fee growth in H1, combined with continued productivity growth driving short term margins have led to further earnings upgrades.

We also note SThree's forward valuation has been very closely correlated to the UK staffing peer group since early 2022. Clearly, the market is making one of two, or even both, assumptions. Firstly, short term trading performance is meaningless against a backdrop of almost certain H2 downgrades. Secondly, SThree will deliver performance in-line with the peer group.

Whilst we accept that macro conditions have taken a sharp turn for the worse, we would take issue with both the prior assumptions when looking at SThree. Firstly, the macro factors that have so spooked the market have largely been in place since the start of the year but have not yet materialised in what is assumed to be a highly cyclically exposed peer group. Secondly, SThree materially outperformed the peer group through the last external shock and every indication is that this will be repeated. Against this context, a sub 10x PE and 4.1% yield looks very attractive.

- **Positive momentum maintained:** SThree has reported +25% YoY net fee growth for H1 FY22, +23% YoY for Q2. All the key geographical markets delivered constant currency growth in excess of 20% with Contract (+30% YoY) continuing to outstrip Perm (+11% YoY).
- **Contractor order book strength underpins H2:** Unlike many of its peers, SThree's contract focus does provide a degree of forward visibility into H2. The +35% contractor order book growth for H1 is highly impressive and underscores the high levels of client and candidate activity across the group. There is little indication at the moment of any tangible slowdown in the group's core markets.
- **Productivity gains continue in FY22:** Alongside net fee growth, productivity gains have been the standout feature of the post pandemic recovery so far. However, the company has consistently flagged headcount growth and internal systems investment, both of which are expected to impact H2 margins and make the likely H1 margin outcome difficult to sustain for the full year.
- **Estimate upgrades.** We upgrade our FY22 net fee / PBT estimates to **£412.3m** (+6%) / **£71.5m** (+8%) respectively. We assume a high single digit H2 net fee outcome and then roll through our existing net fee growth and margin gain assumptions into FY23, but off a higher FY22 base. We still see internal investments holding back the pace of margin gains in FY23 but expect the group to maintain a degree of the productivity gains delivered over the last 18 months.

November, £m	Net Fees	PBT adj	EPS (p)	Div (p)	Net Cash	Fiscal PER x	Yield %
FY 2020A	308.6	30.1	13.5	5.0	49.9	23.7	1.6
FY 2021A	355.7	60.0	30.8	11.0	57.5	10.4	3.4
FY 2022E	*412.3*	*71.5*	*35.5*	*13.1*	*73.9*	*9.0*	*4.1*
FY 2023E	*442.1*	*78.9*	*38.4*	*14.2*	*89.7*	*8.3*	*4.5*
FY 2023E	*476.7*	*89.1*	*43.3*	*16.0*	*112.1*	*7.4*	*5.0*

Source: Radnor Capital Partners

Q2 Trading Update – Key highlights

- H1 FY22 reported net fees £203.1m (+25% YoY constant currency) with Q2 net fees +23% YoY
- The Contractor Order Book (the single best measure for forward visibility) ended Q2 +35% YoY
- Net cash at the end of May 2022 of £48m, in line with May 2021 and down from the £57.5m reported at the last year end. SThree is a net absorber of working capital as underlying net fee income grows, which is a natural function of SThree's contract economics and a key competitive barrier to entry.
- By region, on a constant currency basis and YoY:
  - **DACH** (35% of group net fees) +24% for H1, +23% in Q2
  - **EMEA** (37% of group net fees) +28% for H1, +26% in Q2
  - **USA** (25% of group net fees) +21% for H1, +16% in Q2
  - **APAC** (3% of group net fees) +47% for H1, +32% in Q2
- By business type:
  - **Contract** (77% of group net fees) +30% for H1, +29% in Q2
  - **Permanent** (23% of group net fees) +11% for H1. +5% in Q2

Critically for SThree, all of the group's key regions and also all of the Top 5 individual markets delivered net fee growth greater than 20% in H1.

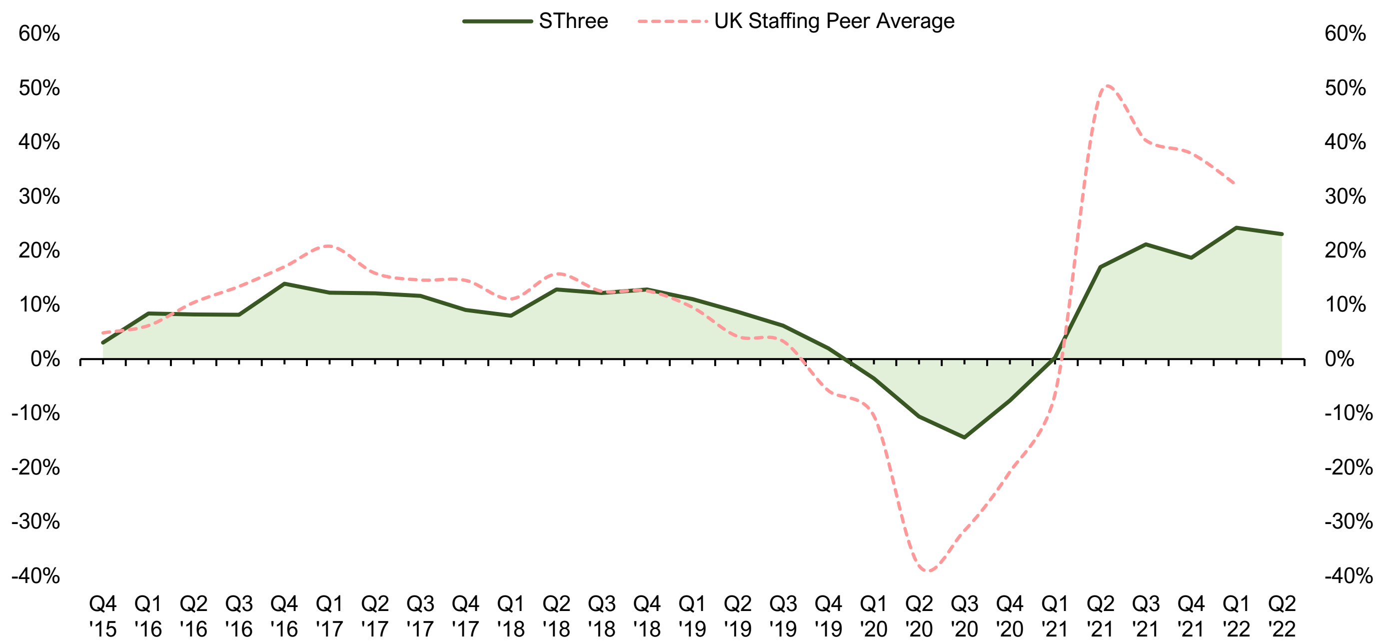
In terms of end discipline, the only negative movement was in Life Sciences Perm (-6% YoY). Given that Life Sciences Contract net fees grew +25% in H1, we see the Perm performance here as being driven primarily by tough comparatives rather than any sense of end market weakness.

We also note the performance of the UK, which for a number of years has been a challenging market for SThree. Although four quarters does not a summer make, this now marks the fourth consecutive quarter of positive YoY growth (+28% in Q2 and +29% in Q1), which does suggest that a corner may have been turned following previous restructuring and management changes. The UK remains well outside the Top 3 largest territories for SThree (it is the 4th largest and delivered £22.2m of net fees in H1).

In Figure 1, overleaf, we show the quarterly net fee track record for SThree since Q1 2016 on a YoY growth basis. We also show the aggregated performance for the UK Staffing peer group (Hays, Page and Robert Walters) as a point of comparison.

The key point here is the extent to which SThree's net fee performance has varied from the peer group, and in particular, the extent to which SThree materially outperformed through the pandemic.

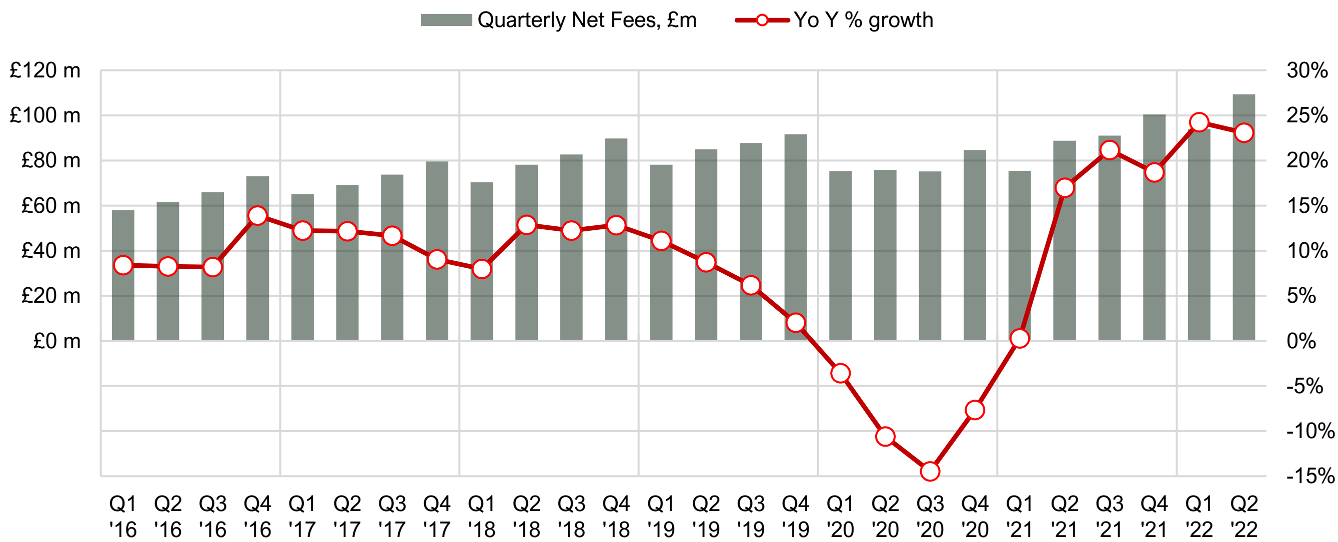
Figure 1: SThree quarterly YoY net fee growth versus UK Staffing peer group average



Source: FactSet, Radnor

In Figure 2 below, we show SThree in isolation and also include the absolute net fee values recorded in each quarter. We can see from here that Q2 2022 was a record quarter for the group in terms of absolute net fee levels.

Figure 2: SThree quarterly net fee income since Q1 2016.



Source: FactSet, Radnor

Estimate revisions and relative valuation

Figure 3: Radnor estimate revisions

		Previous		New		Revision, %	
	FY'21A	FY'22E	FY'23E	**FY'22E**	**FY'23E**	**FY'22E**	**FY'23E**
Group Gross Revenue	**1,330.7**	**1,561.8**	**1663.6**	**1,649.3**	**1,768.2**	***+ 6%***	***+ 6%***
EMEA (ex DACH)	127.2	136.1	141.5	145.0	153.7	*+ 7%*	*+ 9%*
DACH	129.4	144.9	156.5	152.7	164.9	*+ 5%*	*+ 5%*
USA	89.3	98.4	106.3	102.9	111.1	*+ 5%*	*+ 5%*
APAC	9.8	11.0	11.5	11.8	12.3	*+ 7%*	*+ 7%*
Group Net Fees	**355.7**	**390.4**	**415.9**	**412.3**	**442.1**	***+ 6%***	***+ 6%***
EBITA	**60.8**	**66.8**	**73.3**	**72.2**	**79.6**	***+ 8%***	***+ 9%***
- margin %	*17.1%*	*17.1%*	*17.6%*	*17.5%*	*18.0%*		
Adj. PBT	**60.0**	**66.1**	**72.6**	**71.5**	**78.9**	***+ 8%***	***+ 9%***
Adj. EPS (p)	**30.8**	**32.8**	**35.4**	**35.5**	**38.4**	***+ 8%***	***+ 9%***
Dividend (p)	11.0	12.2	13.1	13.1	14.2	***+ 8%***	***+ 9%***
Net Cash (Debt)	**57.5**	**71.8**	**84.2**	**73.9**	**89.7**	***+ 3%***	***+ 6%***

Source: Radnor

In Figure 3 above, we highlight our estimate revisions. At the headline level we have upgrade our FY22 net fees / adjusted PBT by +6% / +8% respectively.

Our net fee upgrades are driven primarily by the strength of the H1 performance outlined in the trading update. We have not assumed a similar level of growth flowing through to the full year, not least because the comparatives become increasingly more challenging. On our revised estimates, £412.3m of net fees for FY22, implies £209.2m of net fees to be delivered in H2, compared to £191.4m delivered in H2 FY21, or H2 growth of 9% YoY. Other than the upgrades to FY22, we have maintained our FY23 net fee YoY growth expectations (other than a minor tick up to EMEA ex Dach and a minor tick down for the US). The broad shape of our margin change assumptions are also unchanged, although the starting base in FY22 is higher.

Should Q3 deliver anything in line with Q2, then our expectations for the full year will be looking too cautious. The current absolute level and continuing rate of growth in the contractor order book, does suggest the balance of risks remains skewed to the upside. The only natural point of caution, especially against a weak macro back drop is that Q4 is traditionally SThree's strongest quarter.

We anticipate H1 margins will come in materially ahead of our upgraded fully year margin estimate of 17.5%. The group has been consistent and explicit in guiding the market towards a H1 bias to margins in the current year. The two primary factors in play here are the timing of headcount growth and the planned and clearly communicated internal investment programme.

- H1 headcount grew +10% YoY and +4% sequentially. The timing of headcount growth has been weighted to the most recent quarter so the cost impact will flow through the remainder of the year and will not fully annualise well into FY23. This will inevitably impact on overall productivity, which we anticipate will begin to progressively reduce through the remainder of FY22. We expect to see the pace of headcount growth accelerate through H2.

- Internal investments in IT systems are expected to be material (between 1% and 2% of group net fee income) and will be almost entirely H2 weighted. This P&L cost range has been well flagged to the market and we would focus on the top end of that range as a realistic expectation. We have already factored into our estimates an uptick in capex driven by the capital element of this programme.

Net, net FY22 will appear, superficially, as an unusual year for SThree. H1 margins will not be a guide to the full year outcome and there is every likelihood that the group could see the majority of its profits earned in H1, which would be a reversal of the more traditional seasonal pattern. However, as the investment costs become more evenly spread through FY23, we would expect the more normal H2 profit bias to reassert itself.

In Figure 6 & 7 below, we show the evolution of the two-year prospective PE multiple for both SThree and the Recruitment peer group in the UK (Hays, Page, Robert Walters). We also show the evolution of the SThree PE discount / premium to the same peer group.

Figure 6: 2 Year prospective PE multiple

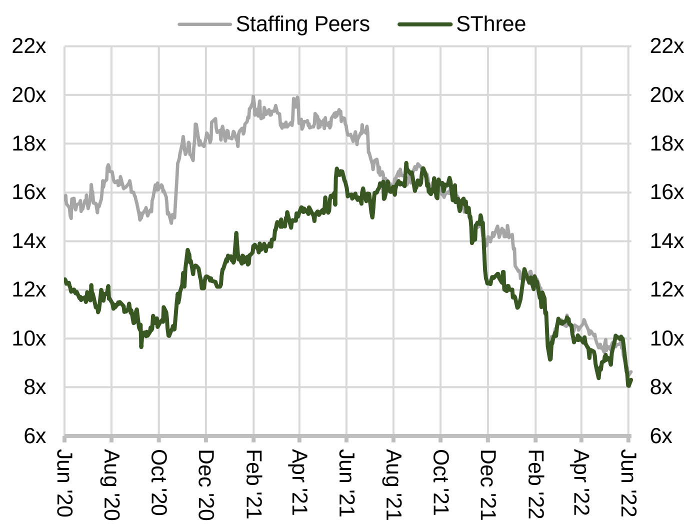
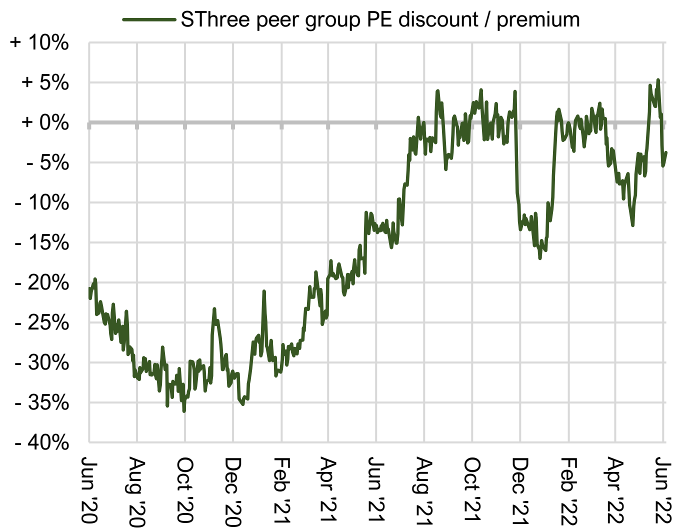


Figure 7: SThree PE discount / premium



Source: FactSet, Radnor

We can see from the above that SThree's forward valuation has been moving in line with the UK Staffing peer group average through much of the second half of 2021 to date. We find this correlation somewhat puzzling give the extent of SThree's outperformance through recent downturns. If the market is indeed pricing in a major cyclical negative shock, then there is a strong argument for SThree trading at a sustained premium to the perm heavy peer group.

With the shares now standing on a FY22 / FY23 PE of 9.0x / 8.3x respectively and a dividend yield of 4.1% / 4.5% we can see an attractive combination of solid top line growth and underlying margin progression at a very attractive entry multiple underpinned by a solid yield.

SThree PLC

STEM

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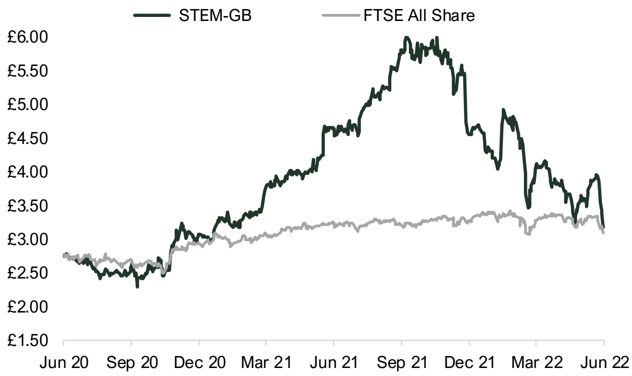
Price (p): **319 p**
Market Cap: 424 m
EV: 374 m

PROFIT & LOSS

Year to 31 November, £m	2020	2021	2022E	2023E	2024E
Group Sales	**1,202.6**	**1,330.7**	**1,649.3**	**1,768.2**	**1,907.0**
EMEA (ex DACH)	*117.6*	*127.2*	*145.0*	*153.7*	*162.9*
DACH	*105.8*	*129.4*	*152.7*	*164.9*	*179.7*
USA	*77.2*	*89.3*	*102.9*	*111.1*	*121.1*
APAC	*7.9*	*9.8*	*11.8*	*12.3*	*13.0*
Group Net Fees	**308.6**	**355.7**	**412.3**	**442.1**	**476.7**
Op. Exp.	(257.8)	(276.6)	(322.6)	(345.9)	(370.4)
EBITDA	**50.7**	**79.1**	**89.8**	**96.2**	**106.3**
Depr & Amort	(6.4)	(6.3)	(6.6)	(6.6)	(6.6)
Lease Depreciation	(13.0)	(12.0)	(11.0)	(10.0)	(10.0)
EBITA - Adjusted	**31.3**	**60.8**	**72.2**	**79.6**	**89.7**
Associates & JV's	-	-	-	-	-
Net Bank Interest	(1.2)	(0.8)	(0.7)	(0.7)	(0.6)
PBT - Adjusted	**30.1**	**60.0**	**71.5**	**78.9**	**89.1**
Non Operating Items	(1.3)	-	-	-	-
Other Financial Items	-	-	-	-	-
PBT - IFRS	**28.8**	**60.0**	**71.5**	**78.9**	**89.1**
Tax - Adjusted	(11.7)	(17.9)	(22.9)	(26.0)	(29.4)
Tax rate - Adjusted	*39.0%*	*29.8%*	*32.0%*	*33.0%*	*33.0%*
Minority interests	-	-	-	-	-
No. shares m, diluted	136.4	136.7	137.0	137.5	138.0
Adj EPS (p), diluted	**13.5**	**30.8**	**35.5**	**38.4**	**43.3**
Total DPS (p)	5.0	11.0	13.1	14.2	16.0

PRICE CHART - 2 YEAR ABSOLUTE vs FTSE ALL SHARE



Source: FactSet

SHAREHOLDERS

	% of ord. Share capital
Kempen Cap Mgmt	9.3%
JO Hambro Cap Mgmt	6.2%
BlackRock	5.2%
Allianz Global	4.5%
JPMorgan AM	4.4%
Polar Capital	4.3%
Littlejohn & Co	4.0%
	37.9%

CASH FLOW

Year to 31 November, £m	2020	2021	2022E	2023E	2024E
EBITDA	50.7	79.1	89.8	96.2	106.3
Working Capital	25.3	(26.6)	(18.5)	(17.5)	(18.4)
Provisions / Exceptionals	0.8	2.0	(0.8)	(0.8)	(0.8)
Gross Op Cashflow	**76.9**	**54.5**	**70.5**	**77.9**	**87.1**
Cash Tax	(10.5)	(16.8)	(17.9)	(22.9)	(26.0)
Cash Intererest	0.1	(0.9)	(0.7)	(0.7)	(0.6)
Net Op Cashflow	**66.5**	**36.9**	**51.9**	**54.3**	**60.4**
Capex	(5.3)	(2.6)	(6.0)	(6.0)	(4.0)
Free Cashflow	**61.2**	**34.2**	**45.9**	**48.3**	**56.4**
Dividends	(6.7)	(6.7)	(15.0)	(18.0)	(19.6)
Acquisitions & Inv.	-	-	-	-	-
Other Non Operating	(13.3)	(12.5)	(12.5)	(12.5)	(12.5)
Net Cashflow	**41.3**	**15.1**	**18.4**	**17.9**	**24.4**
Net Cash (Debt)	**49.9**	**57.5**	**73.9**	**89.7**	**112.1**

Announcements

Date	Event
20 June 2022	Q2 update
21 March 2022	Q1 update
31 January 2021	FY21 results
13 December 2021	Q4 update
13 September 2021	Q3 update
19 July 2021	H1 FY21 results

RATIOS

	2020	2021	2022E	2023E	2024E
RoE	14.3%	26.6%	25.1%	23.2%	22.0%
RoCE	39.8%	60.4%	60.3%	57.8%	56.5%
Asset Turnover (x)	0.2x	0.1x	0.1x	0.1x	0.1x
NWC % Revenue	4.8%	6.0%	5.9%	6.5%	7.0%
Op Cash % EBITA	245.7%	89.6%	97.7%	97.8%	97.0%
Net Debt / EBITDA	1.0x	0.7x	0.8x	0.9x	1.1x

BALANCE SHEET

Year to 31 November, £m	2020	2021e	2022E	2023E	2024E
Intangibles	4.4	2.5	2.5	2.5	2.5
P,P+E	40.8	38.1	38.7	39.3	41.9
Tax Asset & Other	1.5	4.5	4.5	4.5	4.5
Total Fixed Assets	**46.7**	**45.0**	**45.6**	**46.2**	**48.8**
Current Assets	237.4	298.0	351.3	374.9	404.3
Current Liabilities	(179.5)	(218.4)	(253.2)	(259.3)	(270.2)
Net Current Assets	**57.9**	**79.6**	**98.1**	**115.6**	**134.0**
Long Term Liabilities	(26.0)	(24.0)	(24.0)	(24.0)	(24.0)
Net Cash (Debt)	49.9	57.5	73.9	89.7	112.1
Net Assets	**128.5**	**158.1**	**193.6**	**227.5**	**271.0**

VALUATION

Fiscal	2020	2021	2022E	2023E	2024E
P/E	23.7x	10.4x	9.0x	8.3x	7.4x
EV/EBITDA	7.4x	4.7x	4.2x	3.9x	3.5x
Div Yield	1.6%	3.4%	4.1%	4.5%	5.0%
FCF Yield	16.4%	9.2%	12.3%	12.9%	15.1%
Net Fees growth	-8.7%	15.3%	15.9%	7.2%	7.8%
EPS growth	-58.3%	128.6%	15.1%	8.4%	12.5%
DPS growth	-2.0%	120.0%	19.4%	8.4%	12.5%

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