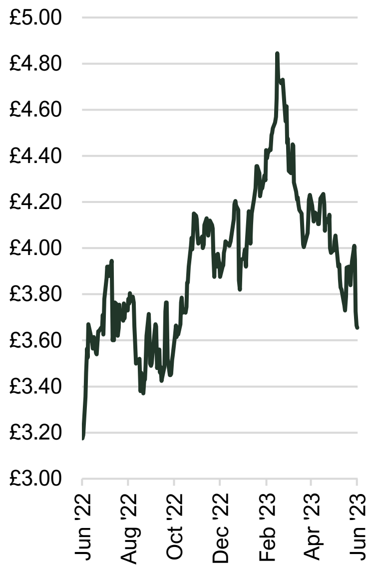
SThree PLC

STEM | Small Cap | Support Services | 365p | £485m

H1 update – Clear blue water opening up to peers

1 Year Chart



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

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The H1 trading update has confirmed the trends seen in the Q1 update. Contract extensions and renewals continue to outperform initial expectations whilst new business activity remains challenging. The biggest change in Q2 has been the acceleration in the decline of Permanent activity, which is a trend we have seen from others in the peer group. Critically for SThree, whose strategic focus lies in high value, skill specific Contract, this downside has been largely offset in terms of both net fee, but most importantly, margin impact. Although we are taking this opportunity to dial back our FY23E expectations, the quantums are nowhere near what we have seen from the other listed peers.

The clear blue water that now stands between SThree and its peers poses a challenge to a market that continues to value SThree at a material discount. The fact that SThree offers, by some distance, the highest absolute EBIT margins and lowest margin volatility in the peer group combined with a clearly more resilient net fee line continues to feel more than a little anomalous. We have believed for some time now that SThree offers the highest quality of earnings in the peer group and should actually trade at a valuation premium. The support of a strong balance sheet alongside the upside potential from a technology improvement programme that could underpin 21% plus margins over the medium / long term are, in our view, not in the current price at all.

- **Softer Q2 following a solid Q1:** Overall, H1 net fees have come in -2% YoY on constant currency basis and +3% post FX, with Q2 -7% pre FX. The key variance here is resilience in Contract (+3% YoY in H1) versus a -19% decline in Permanent net fees. Similarly to the Q1 update; contract extensions and renewals continue to exceed initial expectations whilst new business activity remains challenging. Interestingly, the Q2 exit rate into Q3 was stable.
- **Productivity continues to normalise:** In line with previous updates, H1 saw productivity continue to revert (-7% YoY, -5% in Q1) down the elevated levels of the last two years. It is worth re-iterating that productivity remains +28% ahead of pre-pandemic levels, even before any positive impact from the technology improvement programme, with roll out starting in H2 FY23.
- **Estimate changes.** We are taking this opportunity to scale back our FY23 expectations. FY23E net fees / PBT and EPS are reducing by 6% / 12% / 9% respectively. This is driven primarily by the Q2 weakness in Perm. Encouragingly, management have spoken to a better end to Q2 and into Q3, which suggests a degree of stability returning to the market. Unlike others in the sector, we do not anticipate a significant margin impact and now look for EBIT margins of 17%, which includes £6m-£7m of technology investment expense.

YE November, £m	Net Fees	PBT adj	EPS dil. (p)	Div (p)	Net Cash	Fiscal PER x	Yield %
FY 2021A	355.7	60.0	30.8	11.0	57.4	11.9	3.0
FY 2022A	430.6	77.0	39.9	16.0	65.4	9.2	4.4
FY 2023E	*418.4*	*71.6*	*38.1*	*15.2*	*93.1*	*9.6*	*4.2*
FY 2024E	*448.4*	*79.9*	*41.5*	*16.6*	*96.4*	*8.8*	*4.5*
FY 2025E	*473.7*	*92.9*	*47.6*	*19.0*	*114.6*	*7.7*	*5.2*

Source: Radnor Capital Partners

Q2 trading update – Key highlights

- H1 net fees **£208.6m** (**-2% on a constant currency** basis and +3% post FX). Q2 net fees **£120.6m (-7% on a constant currency** basis and -3% post FX).

- Contractor Order Book (the best measure for forward visibility) ended H1 **flat YoY.** The group now has visibility over c.70% plus of the FY23E net fee outcome.

- **H1 Contract** net fees (**81%** of the group total) grew **+3% YoY** and showed resilience across all the group's key markets with the exception of the USA, where Life Sciences contract net fees declined -16%. Although the company does not break down region net fees by skill perspective, it would seem clear that non-Life Science contract net fees in the USA held up much better (low single digit growth).

    → DACH +1%

    → Netherlands +7%

    → Rest of Europe +5%

    → USA -2%

    → Middle East & Asia +52%

- **H1 Permanent** net fees (**19%** of the group total) declined -19% YoY. Q2 saw a much more uniform negative performance compared to Q1, with Perm down in all the group's key markets. Life Sciences was the largest driver here -43% across the group as a whole as the sector has continued to suffer from the combination of post pandemic hangover and tough comparatives.

- H1 period end **headcount** was down -9% vs Q4 2022 although this includes the restructuring of a number of smaller offices. Like for like quarter end headcount was down -7%. Average headcount in H1 was still up +5% against H1 2022. Underneath the headlines, Permanent headcount saw the biggest decline while Contract headcount saw some small growth. This is in line with the group's strategy of focusing investment behind the core Contract business.

- In line with the Q1 update commentary, productivity continues to revert back from the supra-normal levels recorded in the "hot" post Covid period. H1 productivity was -7% (-5% in Q1) although this remains 28% ahead of pre-Covid productivity levels.

- H1 closing net cash of **£72m**, +50% YoY, including £10m of shares bought back to settle EBT liabilities.

Changes to Radnor estimates

SThree has been highlighting the challenging new business backdrop for some time now. However, better than initially expected contract extensions and renewals had largely offset the new business headwind. Despite the resilience of the group's Contract business (+3% in H1) the weaker Perm business (-19% in H1) will make full year expectations tough to meet. We note management commentary around a stable entry into H2, which provides a degree of confidence that the shorter term environment does not appear to be worsening.

Figure 1: Radnor estimate revisions

		Previous		New		Revision, %	
	FY'22A	FY'23E	FY'24E	FY'23E	FY'24E	FY'23E	FY'24E
Group Gross Revenue	**1,639.4**	**1,693.7**	**1816.6**	**1,591.0**	**1,705.0**	***- 6%***	***- 6%***
DACH	148.9	153.9	164.5	142.4	152.3	*- 7%*	*- 7%*
Netherlands	75.7	78.5	84.7	79.1	85.3	*+ 1%*	*+ 1%*
Rest of Europe	73.1	75.1	78.8	70.5	74.0	*- 6%*	*- 6%*
USA	111.5	115.8	126.5	105.6	115.1	*- 9%*	*- 9%*
ME & Asia	21.4	22.2	23.3	20.8	21.8	*- 6%*	*- 6%*
Group Net Fees	**430.6**	**445.5**	**477.8**	**418.4**	**448.4**	***- 6%***	***- 6%***
EBITA	**77.6**	**82.1**	**89.9**	**71.1**	**79.4**	***- 13%***	***- 12%***
- margin %	*18.0%*	*18.4%*	*18.8%*	*17.0%*	*17.7%*		
Adj. PBT	**77.0**	**81.4**	**89.3**	**71.6**	**79.9**	***- 12%***	***- 11%***
Adj. EPS (p)	**39.9**	**42.0**	**45.3**	**38.1**	**41.5**	***- 9%***	***- 8%***
Dividend (p)	16.0	16.8	17.4	15.2	16.6	*- 9%*	*- 4%*
Net Cash (Debt)	**65.4**	**70.6**	**80.7**	**93.1**	**96.4**	***+ 32%***	***+ 19%***

Source: Radnor

We are reducing our net fee estimates by -6% for FY23.

- We had already been looking for an -8% decline in Perm net fees in FY23 vs FY22 and take this down by a further 5% to -13% YoY.

- For Contract, we are reducing our FY23 estimate by -6% and now look for a broadly flat YoY outcome.

- Geographically, the largest reduction has been in the USA, where Life Sciences has been weak as the global pharmaceutical industry retrenches post Covid. This is likely to be especially pronounced in SThree's Perm business where we now look for a mid teens decline in FY23 compared to a low single digit decline in Contract.

- Although we continue to view SThree as a less operationally geared model compared to other UK recruiters, any reduction in net fees will amplify further down the P&L and we reduce our FY23 EBIT margins by 140 basis points to 17%, which drives a -13% reduction our FY23 EBIT estimate.

  → As we discuss later in this note, it is important to note here that our 17% EBIT margin estimate is taken after the £6m - £7m of P&L investment in the Technology Improvement Programme, which remains on track and on budget. Pre technology investment, we estimate underlying EBIT margins would be closer to 18.4%, which remain ahead of FY22 and FY21.

  → Even at 17%, SThree EBIT margins remain the highest in the UK peer group. Despite the well flagged, partial reversion of heightened productivity experienced over the last two years, SThree's relative margin resilience demonstrates the benefits of a more targeted approach to headcount investment.

- A natural consequence of slowing net fee growth is the release of working capital invested in the Contract book and we increase our FY23 net cash estimate by 32% to £93.1m.

SThree's continuing relative outpeformance 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.

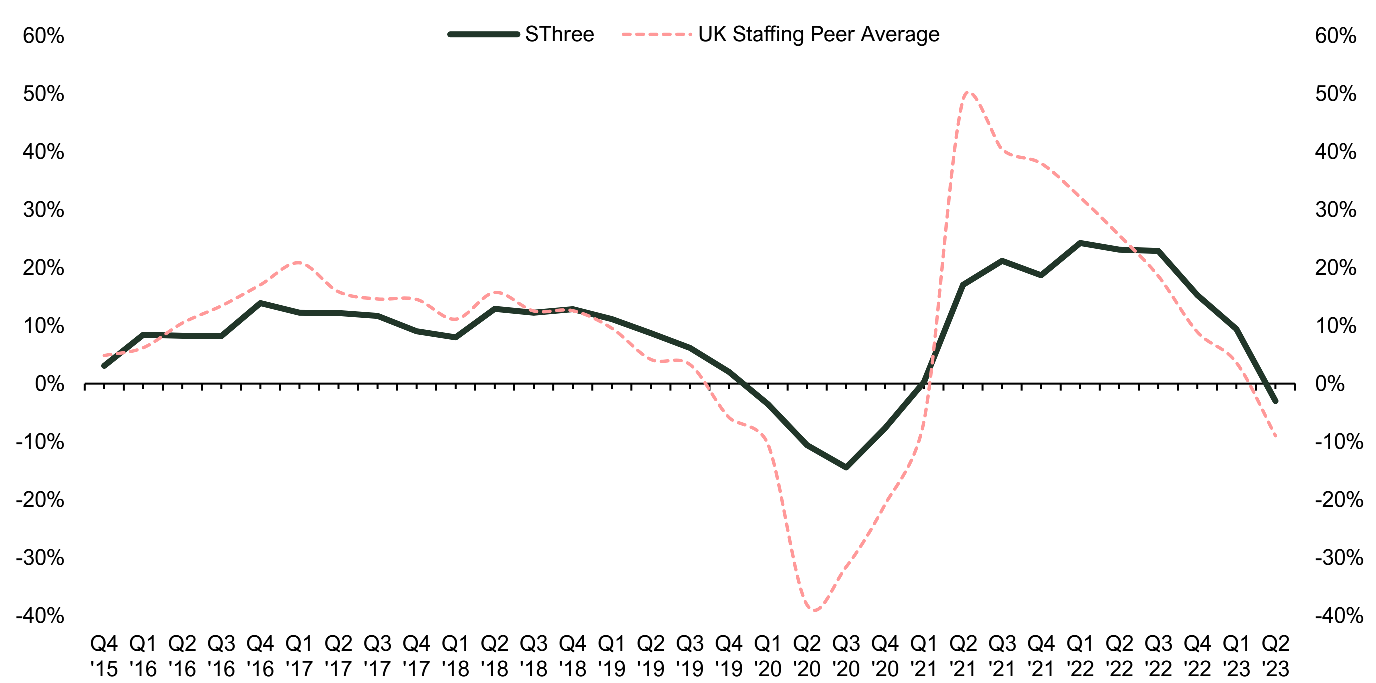
→ **New business** has been more challenging, a point that the company has been explicit around for at least the last two quarters. However, initial effects had varied across the group, becoming more uniform as the year has progressed.

We have highlighted in previous research notes that this interplay between the "installed" 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. This comparison has been made even starker by the extent of the recent downgrades at Robert Walters.

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 FY1 estimates have evolved across the peer group over the course of the last year (Fig 3 and 4).

Figure 2: SThree vs Peers – Consensus Net Fees YoY growth



Source: Radnor

Below in Figures 3 and 4, we show the evolution of FY1 consensus estimates for Net Fees and PBT for SThree and the peer group, rebased to SThree, over the last 12 months.

Figure 3: SThree vs Peers – Consensus Net Fees

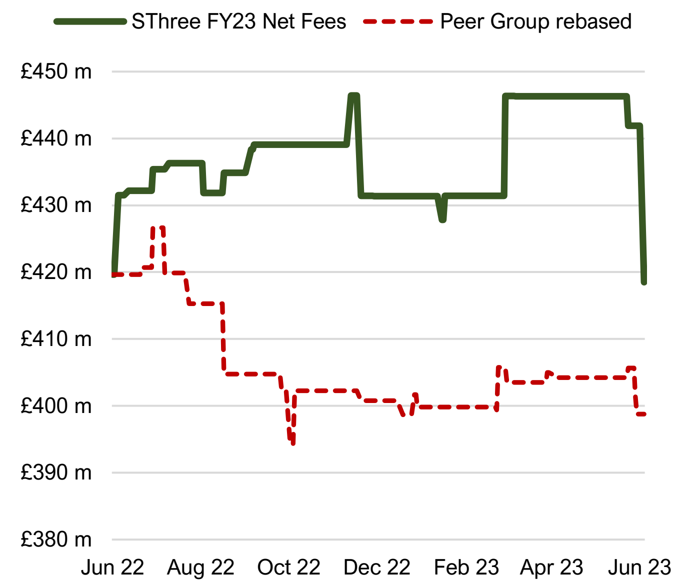
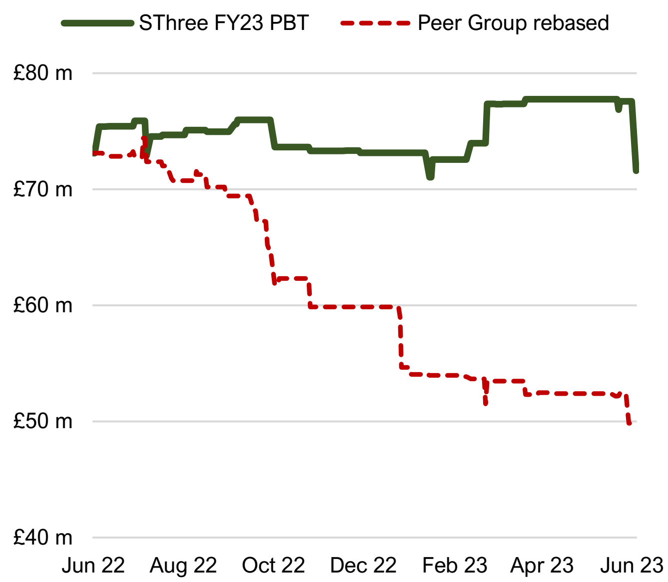


Figure 4: SThree vs Peers – Consensus PBT



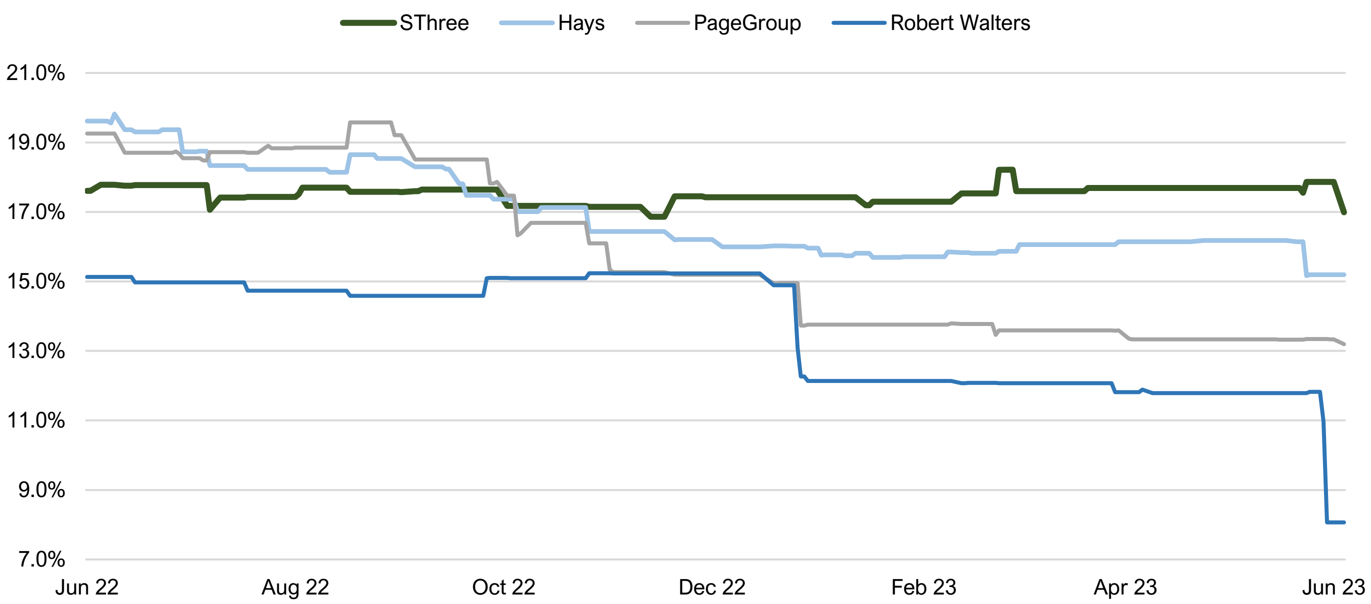
Source: Radnor, FactSet

What does this tell us?

- Since June 2022, the peer group has seen FY23 expectations for Net Fees and PBT downgraded in aggregate by **-5%** and **-32%** respectively.
- By contrast, SThree has seen FY23 PBT and Net Fee expectations change by **-0%** and **-3%** respectively**.**

When we look at this on a company by company basis and focus solely on the change in expectations around EBIT margin, again we can see a dramatic variance across the UK listed peer group.

Figure 5: SThree vs Peers – FY1 EBIT margin expectations over the last 12 months



Source: Radnor, FactSet

We can see from the above that:

- Market consensus has seen SThree delivering the **highest** EBIT margins in the peer group since November 2022;

- SThree margin expectations have **declined** only **120 basis points** from their peak, compared to **460 basis points** for Hays**, 640 basis points** for PageGroup and **720 basis points** for Robert Walters.

- SThree's margin expectations for FY1 are taken **after** the cost of the Technology Improvement Programme, which accounts for £6m - £7m of P&L expense in FY23. On an underlying, pre-investment basis, we estimate EBIT margins would be **18.6%.**

This last point around the Technology Improvement Programme is significant for SThree. Beyond the desire to implement a best in class technology platform that will underpin SThree's client and candidate proposition and execution over the medium to long term; the key outcome from this material (£30m - £35m) investment will be to deliver a structural shift in overall productivity. The ultimate goal here is to drive and sustain group EBIT margins to 21% and beyond.

We explored the Technology Improvement Programme and the potential implications for SThree, both from an operational and financial perspective, in our research note post the FY22 final results (please follow link here).

However, despite the continuing clear blue water between SThree and the UK listed peer group, we continue to see the market unwilling to recognise either the net fee resilience, the sustainability and defensiveness of SThree operating margins, nor the clear upside potential offered by the Technology Improvement Programme. We continue to believe that SThree should, in reality, trade at a sustained premium, not discount, to the peer group.

In Figure 6 & 7 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 6: 1 Year prospective PE multiple

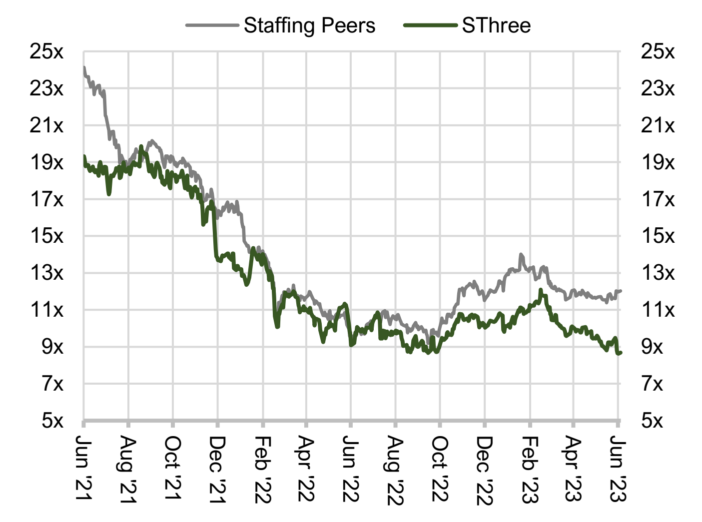
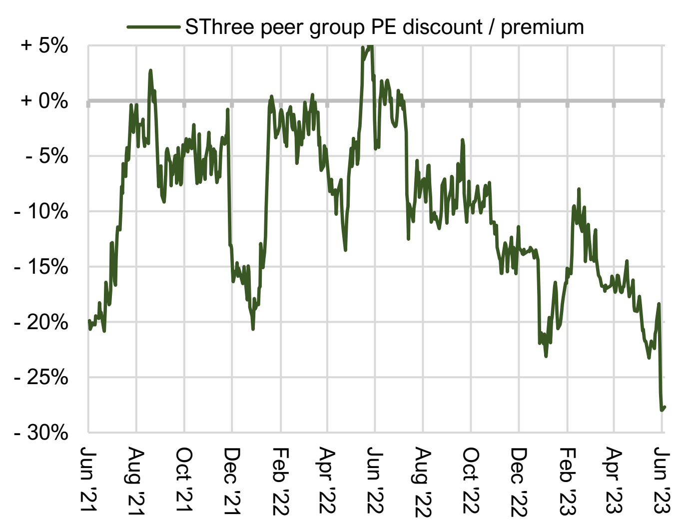


Figure 7: SThree PE discount / premium



Source: FactSet, Radnor

SThree PLC

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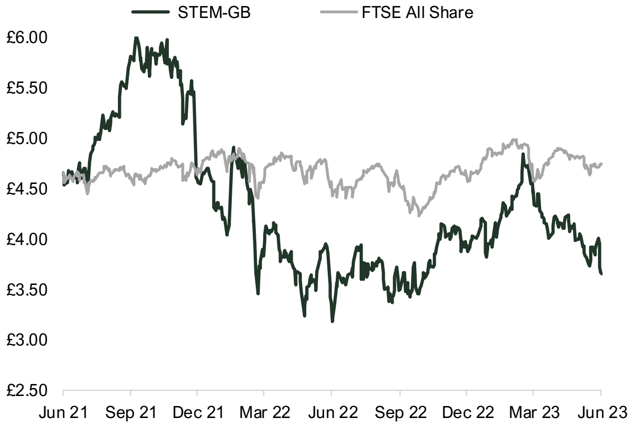
Price (p): **365 1/2 p**
Market Cap: 485 m
EV: 420 m

PROFIT & LOSS

Year to 31 November, £m	2021	2022	2023E	2024E	2025E
Group Sales	**1,330.7**	**1,639.4**	**1,591.0**	**1,705.0**	**1,801.1**
DACH	*129.4*	*148.9*	*142.4*	*152.3*	*160.2*
Netherlands	*57.5*	*75.7*	*79.1*	*85.3*	*90.4*
Rest of Europe	*64.5*	*73.1*	*70.5*	*74.0*	*76.3*
USA	*89.3*	*111.5*	*105.6*	*115.1*	*123.9*
ME & Asia	*15.0*	*21.4*	*20.8*	*21.8*	*22.9*
Group Net Fees	**355.7**	**430.6**	**418.4**	**448.4**	**473.7**
Op. Exp.	(277.2)	(334.2)	(328.1)	(349.5)	(361.5)
EBITDA	**78.5**	**96.5**	**90.3**	**98.9**	**112.2**
Depr & Amort	(4.7)	(5.9)	(6.2)	(6.5)	(6.8)
Lease Depreciation	(13.0)	(13.0)	(13.0)	(13.0)	(13.0)
EBITA - Adjusted	**60.8**	**77.6**	**71.1**	**79.4**	**92.4**
EBITA conversion %	**17.1%**	**18.0%**	**17.0%**	**17.7%**	**19.5%**
Associates & JV's	-	-	-	-	-
Net Bank Interest	(0.8)	(0.5)	0.5	0.5	0.5
PBT - Adjusted	**60.0**	**77.0**	**71.6**	**79.9**	**92.9**
Non Operating Items	-	-	-	-	-
Other Financial Items	-	-	-	-	-
PBT - IFRS	**60.0**	**77.0**	**71.6**	**79.9**	**92.9**
Tax - Adjusted	(17.9)	(22.8)	(20.4)	(23.2)	(27.4)
Tax rate - Adjusted	*29.8%*	*29.6%*	*28.5%*	*29.0%*	*29.5%*
Minority interests	-	-	-	-	-
No. shares m, diluted	136.7	135.9	134.5	136.5	137.5
Adj EPS (p), diluted	**30.8**	**39.9**	**38.1**	**41.5**	**47.6**
Total DPS (p)	11.0	16.0	15.2	16.6	19.0

PRICE CHART - 2 YEAR ABSOLUTE vs FTSE ALL SHARE



Source: FactSet

SHAREHOLDERS

	% of ord. Share capital
Kempen Cap Mgmt	11.0%
JPMorgan AM	6.2%
JO Hambro	5.7%
Littlejohn	4.9%
BlackRock	4.8%
Allianz	4.7%
Polar Capital	3.8%
	41.1%

CASH FLOW

Year to 31 November, £m	2021	2022	2023E	2024E	2025E
EBITDA	78.5	96.5	90.3	98.9	112.2
Working Capital	(26.6)	(38.6)	13.4	(23.2)	(19.6)
Provisions / Exceptionals	2.5	6.5	-	-	-
Gross Op Cashflow	**54.5**	**64.3**	**103.7**	**75.7**	**92.6**
Cash Tax	(16.8)	(18.9)	(22.8)	(20.4)	(23.2)
Cash Intererest	(0.9)	(0.7)	0.5	0.5	0.5
Net Op Cashflow	**36.8**	**44.8**	**81.4**	**55.7**	**69.9**
Capex	(2.6)	(3.7)	(9.0)	(9.0)	(6.0)
Free Cashflow	**34.2**	**41.1**	**72.4**	**46.7**	**63.9**
Dividends	(6.7)	(14.8)	(21.7)	(20.5)	(22.7)
Acquisitions & Inv.	-	-	-	-	-
Other Non Operating	(12.5)	(13.7)	(13.7)	(13.7)	-
Net Cashflow	**15.0**	**12.6**	**37.0**	**12.5**	**41.2**
Net Cash (Debt)	**57.4**	**65.4**	**93.1**	**96.4**	**114.6**

Announcements

Date	Event
20 June 2023	Q2 update
21 March 2023	Q1 update
30 January 2023	FY22 results
14 December 2022	Q4 update
20 September 2022	Q3 update
20 June 2022	Q2 update

RATIOS

	2021	2022	2023E	2024E	2025E
RoE	26.6%	27.1%	24.2%	24.0%	23.8%
RoCE	60.4%	57.4%	59.9%	56.9%	57.7%
Asset Turnover (x)	0.1x	0.1x	0.1x	0.1x	0.1x
NWC % Revenue	6.0%	7.4%	6.7%	7.7%	8.3%
Op Cash % EBITA	89.6%	83.0%	145.8%	95.3%	100.2%
Net Debt / EBITDA	-0.7x	-0.7x	-1.0x	-1.0x	-1.0x

BALANCE SHEET

Year to 31 November, £m	2021	2022	2023E	2024E	2025E
Intangibles	2.5	0.8	0.8	0.8	0.8
P,P+E	38.1	35.2	32.4	29.9	30.8
Tax Asset & Other	4.5	4.6	4.6	4.6	4.6
Total Fixed Assets	**45.0**	**40.7**	**37.9**	**35.4**	**36.2**
Current Assets	298.0	363.9	350.0	381.9	407.0
Current Liabilities	(218.4)	(243.2)	(242.7)	(251.4)	(256.9)
Net Current Assets	**79.6**	**120.7**	**107.3**	**130.5**	**150.1**
Long Term Liabilities	(24.0)	(26.4)	(26.4)	(26.4)	(26.4)
Net Cash (Debt)	57.4	65.4	93.1	96.4	114.6
Net Assets	**158.1**	**200.4**	**211.9**	**235.9**	**274.6**

VALUATION

Fiscal	2021	2022	2023E	2024E	2025E
P/E	11.9x	9.2x	9.6x	8.8x	7.7x
EV/EBITDA	5.3x	4.4x	4.6x	4.2x	3.7x
Div Yield	3.0%	4.4%	4.2%	4.5%	5.2%
FCF Yield	8.1%	9.8%	17.3%	11.1%	15.2%
Net Fees growth	15.3%	21.1%	-2.8%	7.2%	5.6%
EPS growth	128.6%	29.5%	-4.6%	9.1%	14.6%
DPS growth	120.0%	45.1%	-4.6%	9.1%	14.6%

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