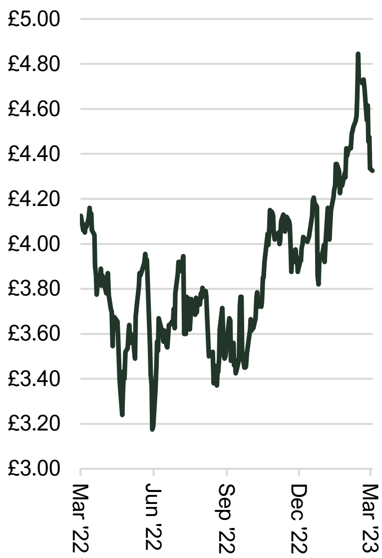
SThree PLC

STEM | Small Cap | Support Services | 432p | £574m

Q1 update – Solid start, no change to estimates

1 Year Chart



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Against a softening macro backdrop, the solidity of SThree's Q1 net fee outcome; +4% YoY at constant currency (+9% post FX), speaks volumes to the resilience of SThree's differentiated focus on both Contract (now 81% of net fees) and STEM disciplines. There are a number of moving parts beneath the headlines – Contract growth vs Permanent declines as well as a degree of regional variation – nonetheless the Q1 outcome was consistent with our full year expectations and we leave our estimates unchanged.

We explore the detail of the trading update below but the key question is what did this update tell the market that it did not already know? The resilience of the SThree differentiated business mix is the key answer here. Tough trading conditions are not new news and have already been flagged by all the recruiters, including SThree. However, this has resulted in material near term earnings downgrades across the peer group with the notable exception of SThree. Not only does the underlying demand for SThree's solution appear more robust than for others, but the strength of the contractor order book at the end of Q1 (+5% YoY), points to a degree of visibility unmatched in the peer group. SThree is by no means immune from the challenging conditions and all eyes will be on the new business commentary at the Q2 trading update.

- **Solid start to what could be an uncertain year:** Q1 net fees were up +4% YoY (constant currency basis). Contract net fees +8% YoY vs a -12% YoY decline in Permanent. SThree has been accelerating the longstanding transition from Perm to Contract and this was particularly pronounced in the US where Contract continued to grow (+4% YoY) while Perm declined (-40% YoY) although this was also impacted by very tough comps within Life Sciences.

- **Productivity beginning to normalise:** In line with previous guidance, Q1 saw productivity begin to revert (-5% YoY) as new hires come on board and net fee growth moderates. SThree is still focused on targeted headcount investment, but overall expectations for full year headcount growth have clearly moderated to flat or low single digit.

- **Estimates unchanged.** We have updated for the new regional reporting format, which now aligns more closely with SThree's internal management structure. Beneath these optical changes, we are not making any material revisions to our estimates. This reflects the solid Q1 net fee outcome, which is consistent with our full year expectations. However, the outlook is by no means certain and the evolving balance between new business activity and existing contract extensions / renewals will be key to the short term direction of estimates.

November, £m	Net Fees	PBT adj	EPS (fully diluted, p)	Div (p)	Net Cash	Fiscal PER x	Yield %
FY 2021A	355.7	60.0	30.8	11.0	57.4	14.0	2.5
FY 2022A	430.6	77.0	39.9	16.0	65.4	10.8	3.7
FY 2023E	*445.5*	*80.2*	*41.3*	*16.5*	*71.1*	*10.5*	*3.8*
FY 2024E	*477.8*	*88.7*	*45.0*	*18.0*	*80.0*	*9.6*	*4.2*
FY 2025E	*505.1*	*102.9*	*51.9*	*20.8*	*100.2*	*8.3*	*4.8*

Source: Radnor Capital Partners

Q1 trading update – Key highlights

- Q1 net fees **£120.6m (+4% YoY constant currency** and +9% post FX). The Contractor Order Book (the single best measure for forward visibility) ended Q1 **+5% YoY**

- **Contract** net fees (**81%** of the group total) grew +8% YoY, with growth across all the group's key markets.

  → DACH +6%

  → Netherlands +9%

  → Rest of Europe +11%

  → USA +4%

  → Middle East & Asia +70%

- **Permanent** net fees (**19%** of the group total) declined -12% YoY. Performance here varied across markets with DACH +11% YoY but the US saw a 40% YoY decline due to a combination of tough comps (US was up +27% YoY on Q1 2022), softer market conditions and also an accelerated shift away from Perm to Contract.

- Headcount at the quarter end was down -4% vs Q4 2022 although this includes the restructuring of a number of smaller offices. On a like for like basis, quarter end headcount was down -2%. Average headcount in Q1 was still up +9% against Q1 2022.

- Q1 closing net cash of **£64m**, +56% YoY.

Outlook - No change to estimates

The Q1 analyst call was, understandably, dominated by current trading conditions and the near term outlook. The key messages here were consistent with previous trading updates. Unlike the Perm heavy peer group, SThree's performance is not just a function of new placement volumes.

→ **Contract extensions and renewals** have actually held up very well and perhaps even better than many would have expected.

→ **New business** is clearly more challenging, although it is still too early to make a definitive call on how this will impact for the full year.

This really is the key point for SThree. With 23% of FY23 net fees already booked (at a growth rate consistent with our full year estimate) and a contractor order book providing good visibility beyond Q2, full year expectations look better insulated than elsewhere in the peer group. Clearly, if new business activity remains depressed through the remainder of the year then current full year expectations will come under pressure but not to the same extent we have seen elsewhere in the peer group.

Previous guidance around headcount growth for the full year had been c.5% and this has clearly moderated to flat / low single digits. Given the natural churn rate in the business (currently running in the low 30% range), we believe this will be achieved through churn management rather than anything more aggressive.

We can see SThree's targeted approach to headcount investment when we look at the detail behind the Q1 headlines. Contract headcount actually grew +14% YoY while Permanent headcount declined -7%. This represents an acceleration of the natural transition from Contract to Perm that has been such a pronounced feature of the SThree story over the last five years.

So how does this play out for SThree relative to the UK listed peer group.

Figure 1: SThree vs Peer Group – Consensus PBT

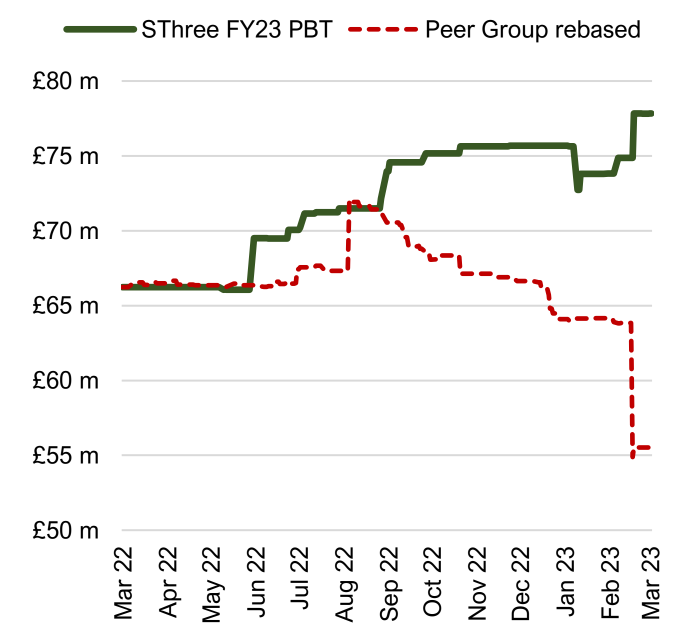
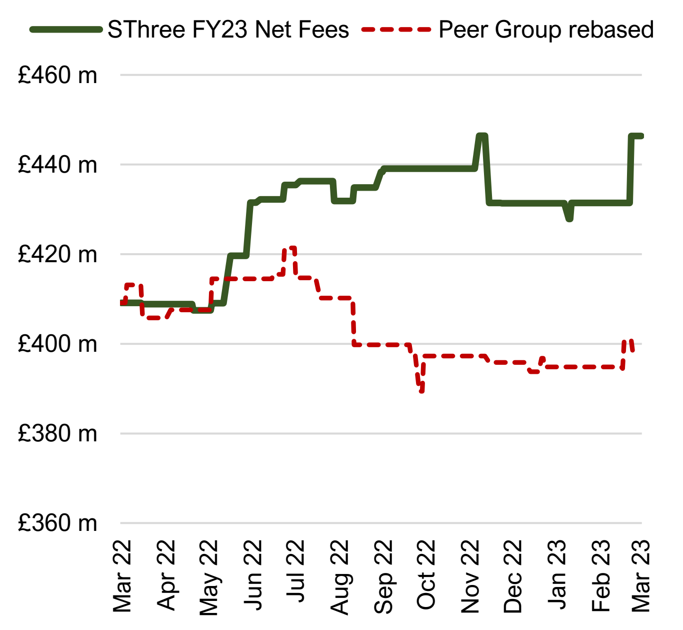


Figure 2: SThree vs Peer Group – Consensus Net Fees



Source: Radnor

In Figures 1 and 2 above, we show the evolution of market consensus for SThree FY23 PBT and Net Fees. We then rebase the same metrics for the peer group (weighted average basis). What does this tell us?

- Since Q3 last year, the peer group has seen FY23 expectations for PBT and Net Fees downgraded in aggregate by **-22%** and **-6%** respectively from their July / August peaks.
- By contrast, SThree has seen PBT and Net Fee market consensus increase by **+8%** and **+3%.**

On the working supposition that markets are somewhat efficient, it would not be unreasonable to expect to see a company that was displaying such a positive differential to its peer group on the two key operating metrics to trade at a premium to the peer group.

The reality is that SThree remains valued at a discount to its more cyclically exposed peers, despite the clear evidence (already provided once during the pandemic) that SThree shows a much higher degree of resilience, and arguably a better quality of earnings, than its peer group. This is before considering the fact that SThree is currently running the highest operating margins in the peer group and that is taken after the costs of a significant technology improvement programme that itself has the potential to drive a step change in SThree profitability.

In Figure 3 & 4 below, we show the evolution of the one-year prospective PE multiple for both SThree and the UK staffing Peer group in the UK (Hays, Page, Robert Walters).

Figure 3: 1 Year prospective PE multiple

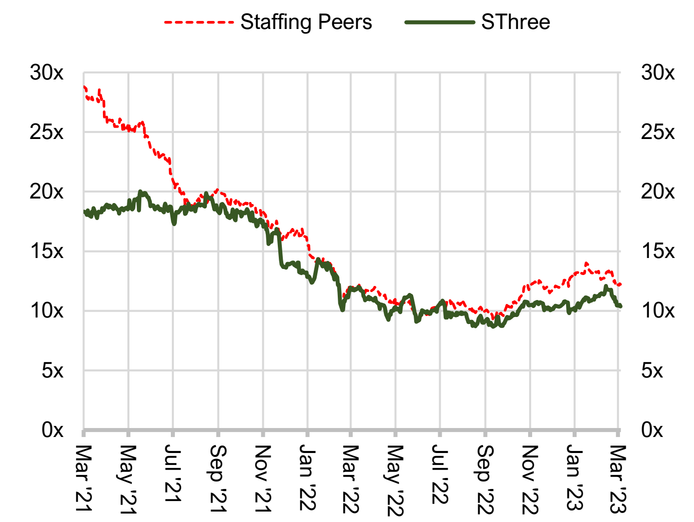
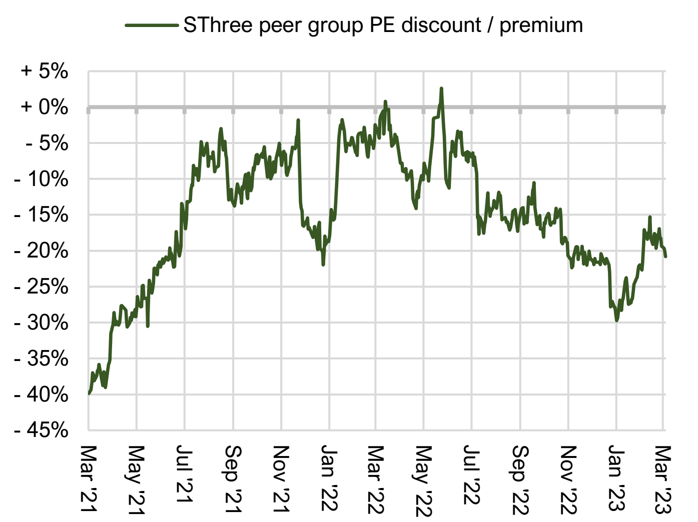


Figure 4: SThree PE discount / premium



Source: FactSet, Radnor

We have long believed that SThree offers a unique play on the structural growth opportunity underpinning STEM skills in modern economies that are undergoing significant technology and energy transitions. Critically, these transitions exist independent of the economic cycle. SThree's contract focus also aligns the group with a flexible working trend that is especially pronounced within highly technically skilled roles. SThree's outperformance through the pandemic, coupled with its technology improvement programme and targeted approach to headcount investment, positions the group well over the medium to long term. Despite its many points of positive differentiation, SThree is not wholly immune from cyclical pressures, but we do believe the case for continued peer outperformance is strong. The current valuation discount to the peer group, in our eyes, continues to offer an interesting opportunity for investors.

SThree PLC STEM

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Price (p): 432 1/2 p
Market Cap: 574 m
EV: 508 m

PROFIT & LOSS

Year to 31 November, £m	2021	2022	2023E	2024E	2025E
Group Sales	**1,330.7**	**1,639.4**	**1,693.7**	**1,816.6**	**1,920.4**
DACH	*129.4*	*148.9*	*153.9*	*164.5*	*173.1*
Netherlands	*57.5*	*75.7*	*78.5*	*84.7*	*89.7*
Rest of Europe	*64.5*	*73.1*	*75.1*	*78.8*	*81.3*
USA	*89.3*	*111.5*	*115.8*	*126.5*	*136.5*
ME & Asia	*15.0*	*21.4*	*22.2*	*23.3*	*24.4*
Group Net Fees	**355.7**	**430.6**	**445.5**	**477.8**	**505.1**
Op. Exp.	(277.2)	(334.2)	(345.5)	(368.9)	(381.7)
EBITDA	**78.5**	**96.5**	**99.9**	**108.8**	**123.4**
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**	**80.7**	**89.3**	**103.5**
EBITA conversion %	**17.1%**	**18.0%**	**18.1%**	**18.7%**	**20.5%**
Associates & JV's	-	-	-	-	-
Net Bank Interest	(0.8)	(0.5)	(0.5)	(0.6)	(0.6)
PBT - Adjusted	**60.0**	**77.0**	**80.2**	**88.7**	**102.9**
Non Operating Items	-	-	-	-	-
Other Financial Items	-	-	-	-	-
PBT - IFRS	**60.0**	**77.0**	**80.2**	**88.7**	**102.9**
Tax - Adjusted	(17.9)	(22.8)	(23.7)	(26.6)	(30.9)
Tax rate - Adjusted	*29.8%*	*29.6%*	*29.5%*	*30.0%*	*30.0%*
Minority interests	-	-	-	-	-
No. shares m, diluted	136.7	135.9	136.9	137.9	138.9
Adj EPS (p), diluted	**30.8**	**39.9**	**41.3**	**45.0**	**51.9**
Total DPS (p)	11.0	16.0	16.5	18.0	20.8

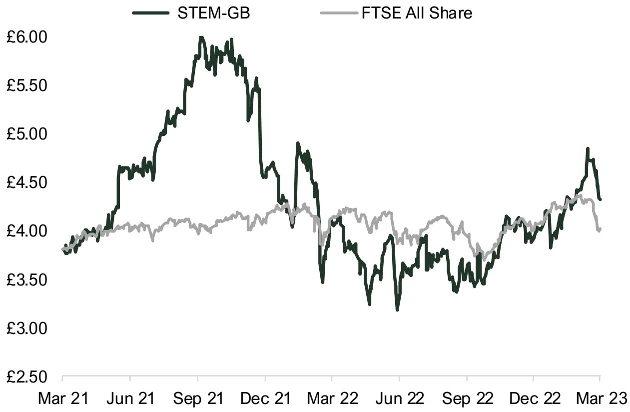
CASH FLOW

Year to 31 November, £m	2021	2022	2023E	2024E	2025E
EBITDA	78.5	96.5	99.9	108.8	123.4
Working Capital	(26.6)	(38.6)	(17.3)	(21.0)	(22.1)
Provisions / Exceptionals	2.5	6.5	-	-	-
Gross Op Cashflow	**54.5**	**64.3**	**82.7**	**87.8**	**101.3**
Cash Tax	(16.8)	(18.9)	(22.8)	(23.7)	(26.6)
Cash Intererest	(0.9)	(0.7)	(0.5)	(0.6)	(0.6)
Net Op Cashflow	**36.8**	**44.8**	**59.4**	**63.6**	**74.0**
Capex	(2.6)	(3.7)	(9.0)	(9.0)	(6.0)
Free Cashflow	**34.2**	**41.1**	**50.4**	**54.6**	**68.0**
Dividends	(6.7)	(14.8)	(21.7)	(22.6)	(24.8)
Acquisitions & Inv.	-	-	-	-	-
Other Non Operating	(12.5)	(13.7)	(13.7)	(13.7)	-
Net Cashflow	**15.0**	**12.6**	**14.9**	**18.2**	**43.2**
Net Cash (Debt)	**57.4**	**65.4**	**71.1**	**80.0**	**100.2**

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	384.5	412.4	437.8
Current Liabilities	(218.4)	(243.2)	(246.6)	(253.4)	(256.8)
Net Current Assets	**79.6**	**120.7**	**137.9**	**158.9**	**181.0**
Long Term Liabilities	(24.0)	(26.4)	(26.4)	(26.4)	(26.4)
Net Cash (Debt)	57.4	65.4	71.1	80.0	100.2
Net Assets	**158.1**	**200.4**	**220.5**	**248.0**	**291.1**

PRICE CHART - 2 YEAR ABSOLUTE vs FTSE ALL SHARE



Source: FactSet

SHAREHOLDERS

	% of ord. Share capital
Kempen Cap Mgmt	10.0%
JPMorgan AM	6.0%
Littlejohn	5.6%
JO Hambro	5.2%
BlackRock	5.0%
Allianz	4.9%
Polar Capital	3.4%
	40.1%

Announcements

Date	Event
30 January 2023	FY22 results
14 December 2022	Q4 update
20 September 2022	Q3 update
20 June 2022	Q2 update
21 March 2022	Q1 update
31 January 2021	FY21 results

RATIOS

	2021	2022	2023E	2024E	2025E
RoE	26.6%	27.1%	25.6%	25.1%	24.8%
RoCE	60.4%	57.4%	54.0%	53.2%	54.2%
Asset Turnover (x)	0.1x	0.1x	0.1x	0.1x	0.1x
NWC % Revenue	6.0%	7.4%	8.1%	8.7%	9.4%
Op Cash % EBITA	89.6%	83.0%	102.4%	98.3%	97.8%
Net Debt / EBITDA	-0.7x	-0.7x	-0.7x	-0.7x	-0.8x

VALUATION

Fiscal	2021	2022	2023E	2024E	2025E
P/E	14.0x	10.8x	10.5x	9.6x	8.3x
EV/EBITDA	6.5x	5.3x	5.1x	4.7x	4.1x
Div Yield	2.5%	3.7%	3.8%	4.2%	4.8%
FCF Yield	6.7%	8.1%	9.9%	10.7%	13.4%
Net Fees growth	15.3%	21.1%	3.4%	7.3%	5.7%
EPS growth	128.6%	29.5%	3.5%	9.0%	15.2%
DPS growth	120.0%	45.1%	3.5%	9.0%	15.2%

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