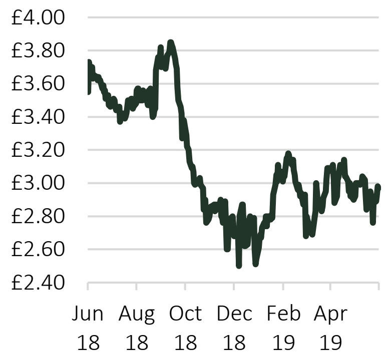
SThree PLC

STHR | Small Cap | Support Services |296p |£386m

Encouraging H1 19 trading update

1 Year Chart



The H1 pre-close update saw positive Q1 trading momentum carry through into Q2. This performance has been delivered despite uncertain macro data. Encouragingly, SThree remarked 'expectations for the full year remain unchanged'. Group H1 net fees + 9% YoY, is a creditable outcome, reflecting a consistent performance across Q1 / Q2. We are leaving our headline FY PBT/EPS forecasts unchanged, although we have made some minor changes to our regional mix. We would also highlight the improving balance sheet position, with net debt down to £8m (£12m at Q2).

The update was also the first opportunity for investors to hear from new CEO, Mark Dorman, who joined SThree in March. Major shifts in strategy are unlikely in our view, as SThree's unique combination of STEM and Contract focus continue to hold it in good stead. Although SThree is some way off its 52 week highs, it is now also some way off its lows, suggesting the more extreme cyclical concerns have now been priced in. Dividend growth remains a positive catalyst. SThree continues to trade at a material discount to the Staffing peer group (FY19E PE of 9.1x, 5.1% yield) despite keeping pace with its more cyclical peers.

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

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

- **H1 update key highlights:** Overall group net fees were £163m, up 9% YoY. Three of SThree's four key regions showed double-digit YoY net fee growth. By target STEM industry, all bar one (Banking & Finance) reported double-digit growth in H1 19, with Energy (+27%) and Engineering (+14%) leading the way. Contract continues to be the main top-line driver, up 12% YoY, consistent with Q1.

- **Relative attractions:** SThree is closely tracking its more Perm heavy peers in terms of prospective net fees and earnings momentum. The Perm heavy model is far more exposed to any initial cyclical shock, which SThree's differentiated Contract positioning is well suited to protect against.

- **Mark Dorman, new CEO:** With Gary Elden's departure, SThree now has a new CEO for the first time since 2013. Our initial takeaway is that the core STEM strategy will not be subject to major change. Mark comes from outside the recruitment sector, so bringing with him a fresh perspective, especially when it comes to optimising SThree's global platform; capital allocation and harnessing technology.

- **Valuation:** The shares have rallied by 9% YTD, in absolute terms. However, SThree's PE discount to the peer group still stands at c.31%. Given SThree's STEM and Contract focus and delivery YTD, there is an argument that the discount should not exist at all at this late point in the cycle. With SThree returning to dividend growth there should also be attractions for investors looking for a combination of growth and income.

24th June 2019

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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	11.9	4.7
FY 2018A	321.1	53.3	29.6	14.5	-4.1	10.0	4.9
FY 2019E	*344.0*	*58.5*	*32.6*	*15.0*	*7.1*	*9.1*	*5.1*
FY 2020E	*362.1*	*63.2*	*35.0*	*15.5*	*18.0*	*8.5*	*5.2*
FY 2020E	*379.1*	*67.2*	*36.9*	*16.0*	*40.7*	*8.0*	*5.4*

Source: Radnor Capital Partners

H1 19 trading update

SThree has delivered a reassuring H1 19 update (May period end), which leaves us confident at this stage in our full year forecasts. SThree last formally updated the market on 15th March 2019 at the Q1 trading update.

Business Performance key highlights

Group net fees + 9% YoY, a growth rate consistent across both Q1 and Q2. Performance was driven by Continental Europe up 13% and USA up 13%. The growth in Continental Europe was driven by DACH with Germany remaining a very attractive market, up 15%. The Netherlands likewise performed well, up 11% YoY. Overall, Europe traded ahead of our expectations for H1.

UK & Ireland saw a 9% decline in net fees, slightly below our expectations. This will clearly be a focus of new CEO Mark Dorman. 2018 was a year of significant internal restructuring of the UK business as the focus narrowed in on headcount productivity rather than absolute scale. There are however some signs of local stabilisation and increased headcount investment. We also note that H2 18 trading comparatives will become easier.

By sector ICT, Life Sciences, Energy and Engineering all delivered strong growth. Only Banking & Finance declined, down 9% YoY in H1.

By business type, Contract continued to be the primary growth driver with net fees up 12%, with a small acceleration from Q1 (+12%) into Q2 (+ 13%). All regions outside of UK&I delivered double digit growth with Continental Europe up 16%, USA up 22% and APAC & MENA up 15%. Continental Europe and USA combined now represent 80% of Contract net fees (H1 2018: 76%).

Average Group sales headcount was up 7% YoY with Continental Europe up 9%, USA up 8%, Japan up 62% and UK&I down 2%. Contract sales headcount represented 69% of total sales headcount at period end (2018: 68%). Average Permanent headcount remained flat and average Contract headcount was up 11%, which again is in line with strategy.

Permanent net fees were down 1% (Q2 -2%) with both UK&I and USA net fees declining, reflecting previously reported restructuring and management changes made during 2018. Offsetting this was strong growth in DACH, the largest Permanent region, up 9% YoY and in Japan, which continues to grow at a very fast rate, up 49% YoY.

Balance Sheet & Net Debt

The H1 2019 SThree net debt position of £8m is a strong result, in our view, and a material unwind from the Q1 position (£12m). Hence gearing is negligible. SThree's strong balance sheet might well also prove a source of comfort to investors, in increasingly uncertain times as well as underpinning a key competive strength of SThree in the Contract market.

DSOs (Days Sales Outstanding – a key cash collection metric) remain on track to improve YoY in FY2019, which suggests a further improvement in overall cash conversion through the fiscal year. FY2018 saw SThree finance and back office functions move from London to Glasgow. This was a major exercise and did have an expected impact on the invoice and collections cycle, which should now be fading out.

It is worth noting that SThree enjoys a substantial deferred cash position represented by the overall net working capital (short term debtors – creditors) position in the balance sheet. In FY2018, this amounted to £93.9m, or 7.5% of gross revenue. By comparison both Robert Walters and Hays had a net working capital position of 4.3% of gross revenue at their respective last full balance sheets. This larger "reversionary" deferred cash position for SThree is a direct function of the growth of the contract book (longer duration cash receipt) versus perm (spot cash).

As an aside, currency will have had negligible impact on H1 19 reported results, with only modest changes YoY in average EUR/GBP and USD/GBP rate.

Outlook statement

'*Our deliberate focus on Contract, a natural function of our STEM specialism, and the continued strength of our performance across key regions and sectors in our well diversified portfolio, provides resilience in today's more uncertain market conditions, whilst also delivering strong growth over the medium term. Following the encouraging start to the year, expectations for the full year remain unchanged*'

In our view, continued momentum in Contract has created a more resilient business, providing stronger, more sustainable and higher quality profits. In addition, the introduction of a Contract-specific management team has increased accountability and focus. The longer duration nature of the Contract book underpins a good portion of SThree's FY19 visibility.

In context, general macro and stockmarket sentiment has been deteriorating through H2 18, and into FY19. So we consider SThree's business momentum and ability to deliver ahead of expectations, particularly encouraging.

Review of key issues/ factors in H1 19:

New SThree CEO

The biggest corporate development at SThree in H1 19 was the appointment of new CEO, Mark Dorman, effective March. Mark succeeded Gary Elden, who had been CEO since 2013.

Prior to SThree, Mark was President of Higher Education, International & Professional for McGraw Hill Education. Before joining McGraw-Hill Education in 2013, Mark was an executive at the likes of Wolters, Gartner Inc. and LexisNexis UK, a unit of Reed Elsevier.

Mark clearly has extensive experience in international strategy, business development and sales and marketing. He is not however a recruitment industry 'insider', which in our view suggests he may in time bring new perspectives to SThree in the context of an evolving sector.

We note Mark's clear affirmation of SThree's established, core strategy of STEM focus in global markets. SThree's positioning and strength of delivery provides Mark with a platform of considerable strength to grow from. Our expectations are for a step change in strategic execution over the medium term although the fundamentals of the SThree proposition are unlikely to change materially. The well-worn phrase "evolution not revolution" is especially apt here. Optimising the UK & Ireland business will also continue as a priority, although we do note that execution and scale in key global markets outside the UK will be the primary driver of growth and value.

More broadly, the recruitment sector (in STEM, and more generally) is seeing innovation and technology-led disruption, like so many industries, and we fully expect Mark to bring his experience of business model evolution outside recruitment to bring a fresh edge to SThree's longer term positioning.

Macro

In context, general macro and stockmarket sentiment has been deteriorating through H2 18, and into FY19. Where are we now on macro, specifically around the Eurozone and UK ?

European sentiment indicators have been mixed through H1, buffeted by renewed escalation of the US-China and potential US-Mexico disputes. With external demand remaining a headwind overall, it is reassuring that private consumption in Germany jumped by the most in eight years in Q1 and that May's service PMI remained in expansionary territory at 52.9. At the same time, ongoing concerns that any manufacturing slowdown could spread to the service sector remain.

Brexit remains unresolved almost three years after the original UK vote, remaining a negative force on business confidence, specifically in the UK and Europe. Although not exposed to the broad spread of economic activity in the UK economy; the moderation in quarterly GDP growth is an unhelpful backdrop for SThree in the UK. In terms of quarterly performance, growth slowed to 0.3% in the three months to April following a 0.5% expansion in the first quarter. It is worth re-iterating at this point that the UK represents less than 15% of SThree net fees.

Dividend

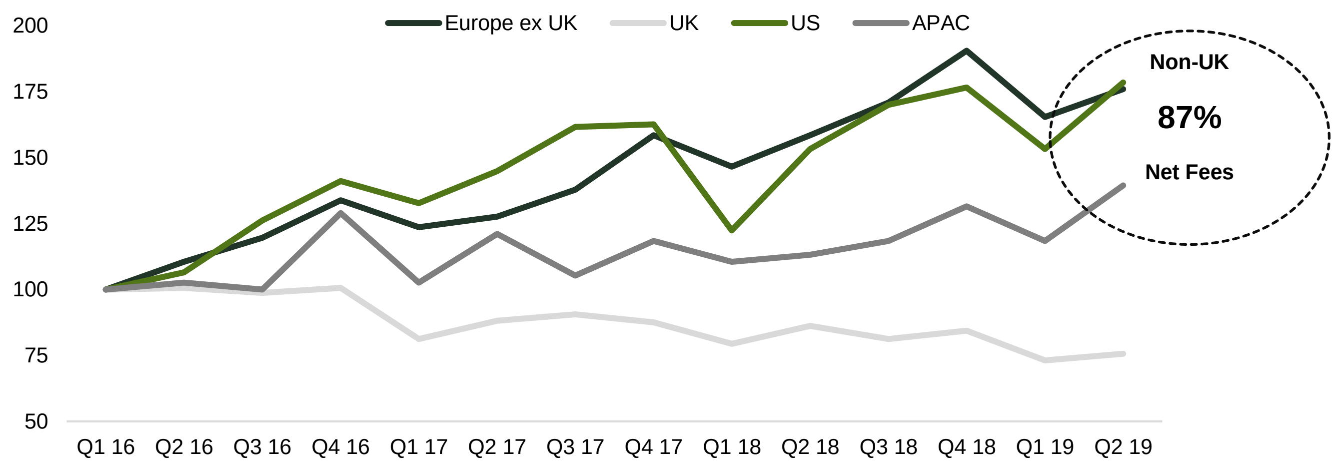
Against this backdrop, we highlight developments – positive in our view – around the SThree dividend policy from earlier this year. To recap, the SThree FY 18 dividend was 14.5p total (9.8p, final), up 4% YoY. We believe investors should be greatly encouraged by increase in the full year dividend, after a number of years of maintained payments.

Dividend cover (EPS /dividend) is over 2x for the first time in a number of years, with a target range of 2-2.5x reiterated by management. We currently assume a gentle rate of dividend increase moving forward, placing the payout at 2.2x to 2.3x cover, however risks remain on the upside here, in our view.

Net fees track record

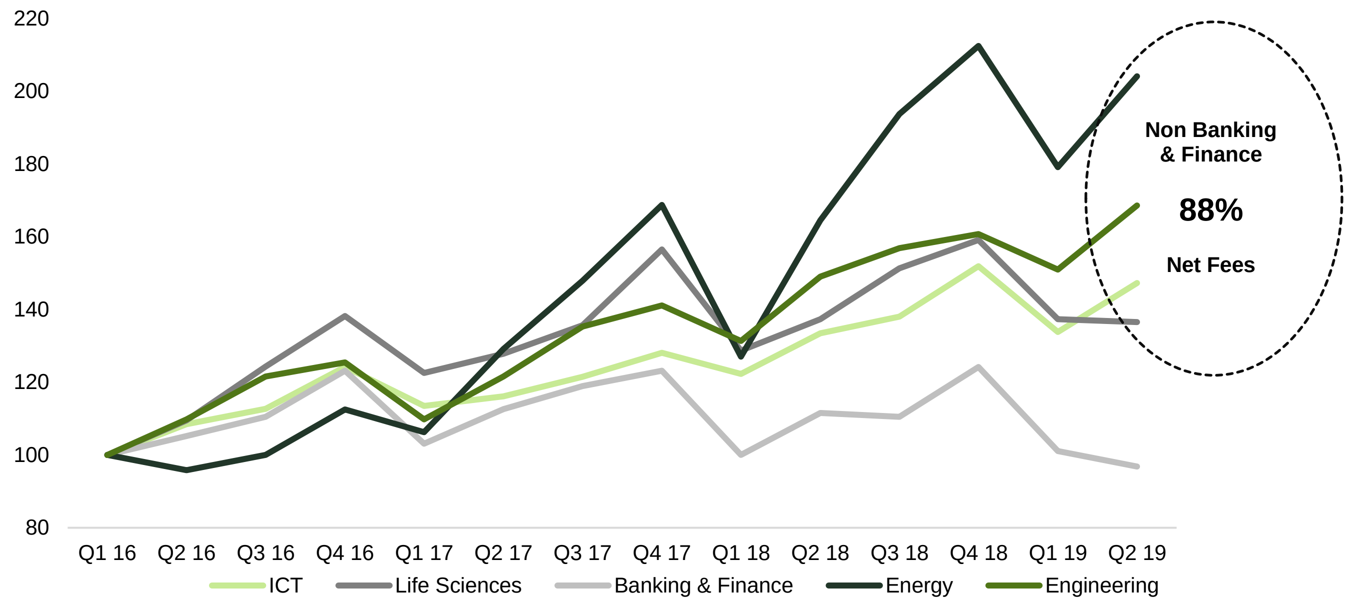
We believe it is worth re-iterating what have been, and continue to be, the key growth drivers for SThree; namely the global focus outside the UK and the key target industry specialisation.

SThree quarterly net fees progression by Region – rebased to 100, Q1 2016



Source: SThree, Radnor

SThree quarterly net fees progression by Industry Vertical – rebased to 100, Q1 2016



Source: SThree, Radnor

We can see from both the charts above that SThree have seen strong net fees growth across the breadth of their business, both on a regional and a target industry basis. Since Q1 2016:

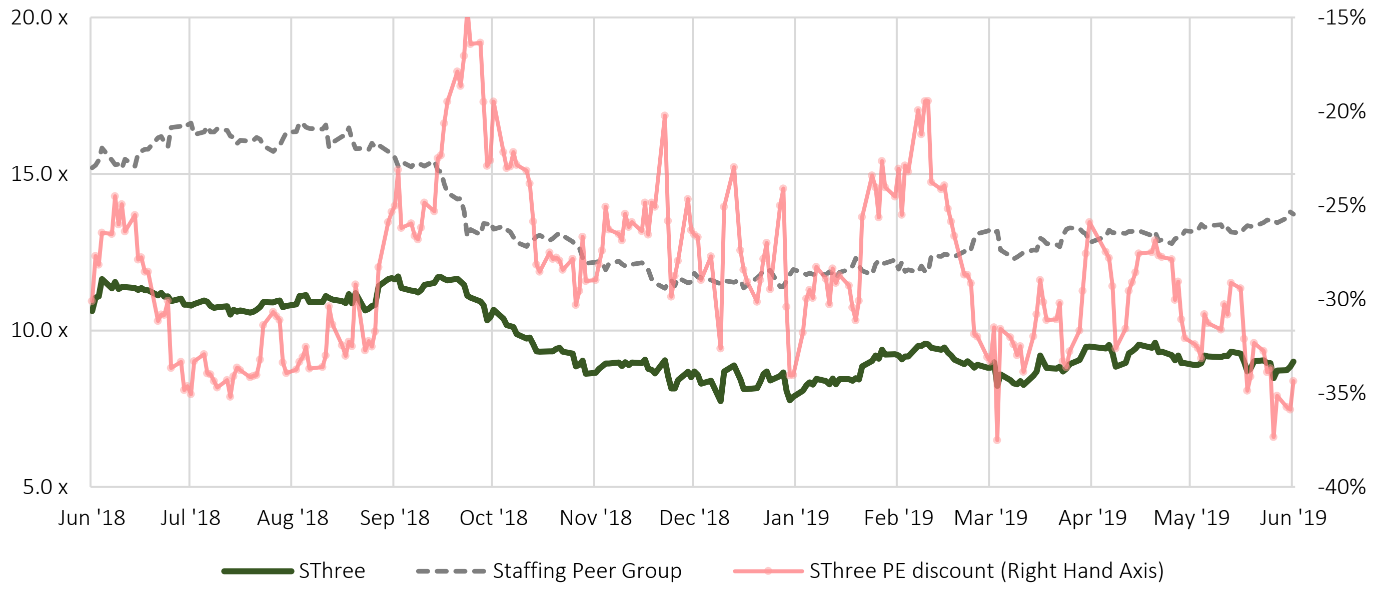
- non-UK quarterly net fees have grown by 73% from £42.0m to £73.0m;
- non-Banking & Finance quarterly net fees have grown by 53% from £47.4m to £72.4m;

We believe the strength and breadth of the group portfolio has been underappreciated by the market; where old perceptions of the SThree being UK and Banking focused remain in place. The success of the portfolio approach to geographical and specialist market led expansion is a fundamental plank of the SThree investment case. This is the platform that the new CEO will be looking to accelerate.

Peer Group valuation

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

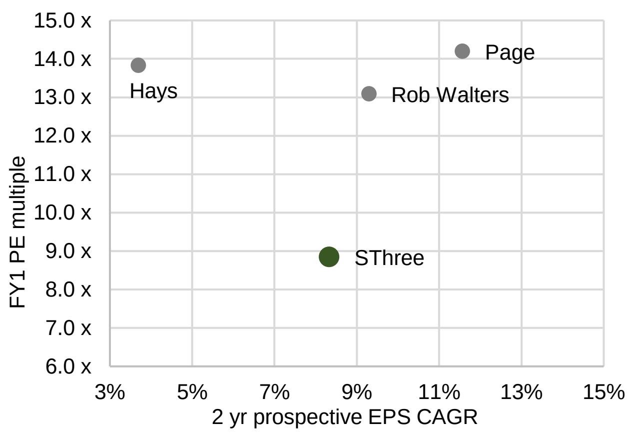


Source: FactSet, Radnor

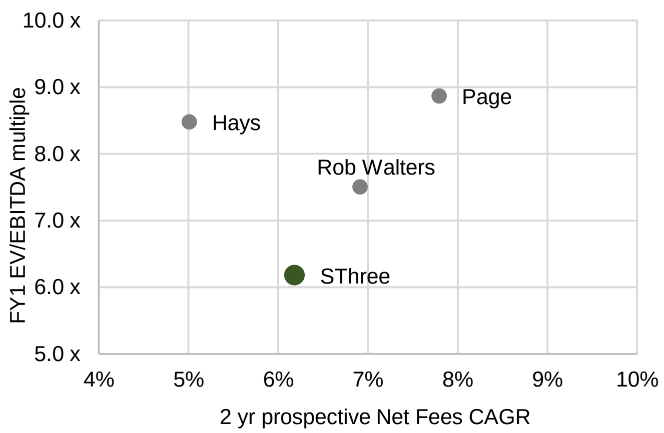
Despite positive recent trading commentary (Q1 and Q2 trading update), the SThree forward PE multiple continues to trade towards the bottom end of its historic discount range relative to the peer group.

We continue to find the disconnect between the consistency of delivered performance and the absolute valuation intriguing. According to market consensus (FactSet), 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



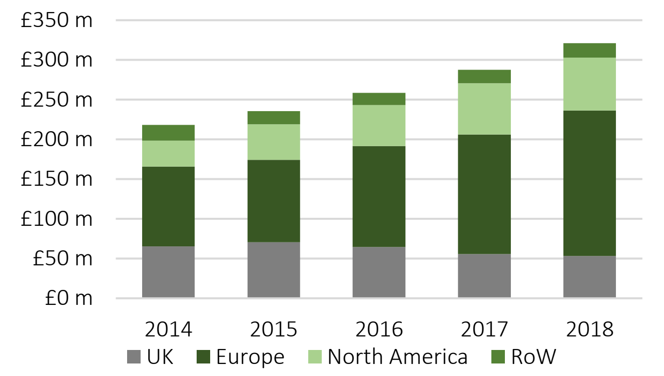
Source: FactSet, Radnor

Key Points – Investment Case

Market Blues	SThree has found itself in the strange position of delivering consistently positive and 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 the finer points of SThree's differentiated, later cycle business model have not fully registered.
Positive Trading	Last week's H1 trading update confirmed a strong top-line YTD, +9% 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 seen consistent **EPS upgrades** from the house brokers (UBS & Liberum) throughout the last two years.
Non-UK Exposure	**85%** of FY18 net fees were 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 (72% of FY18 net fees) relative to Permanent (28% of FY18 net fees). This is partly 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. This range had narrowed through much of 2018 and early 2019 but has widened back out in recent weeks. We believe SThree is less exposed to the headline cyclical risks to be found elsewhere and the current headline prospective PE of 8.8x and dividend yield of 5.3% does not fully recognise SThree's growth and risk characteristics.

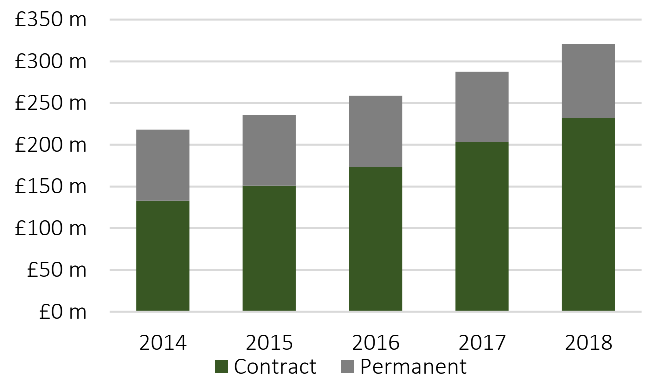
SThree - Key charts

Geographic Net Fees 5 year track record



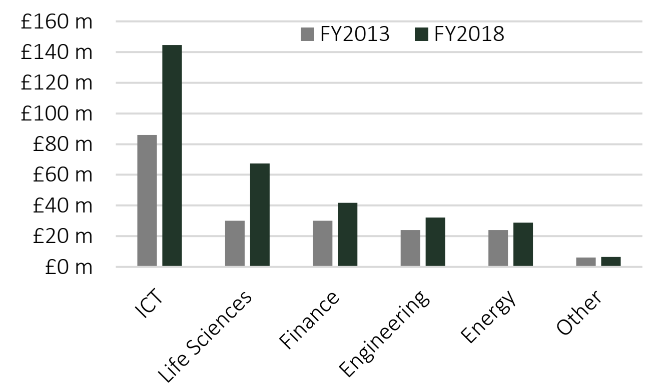
Source: FactSet, Radnor

Contract / Perm Net Fees 5 year track record



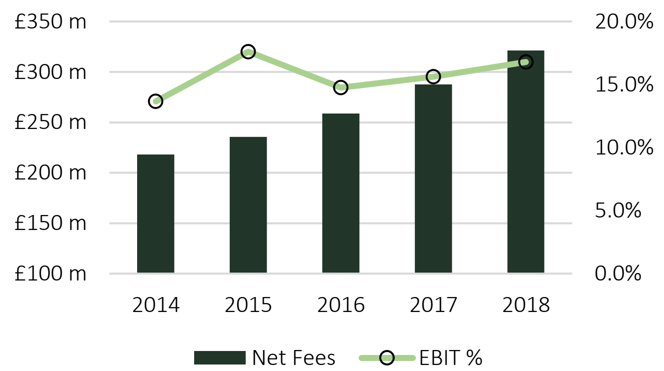
Source: FactSet, Radnor

STEM market Net Fees 2013 vs 2018



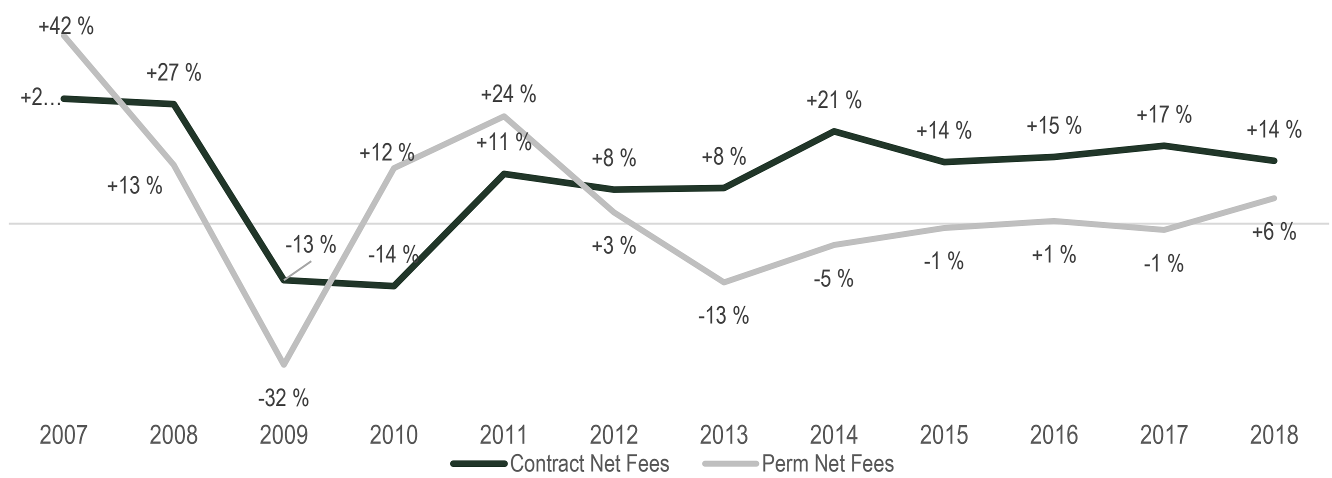
Source: FactSet, Radnor

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): **296 p**
Market Cap: 386 m
EV: 390 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)	(14.6)	(15.8)	(16.8)
Tax rate - Adjusted	*26.3%*	*25.6%*	*26.0%*	*25.0%*	*25.0%*	*25.0%*
Minority interests	-	-	-	-	-	-
No. shares m, diluted	132.0	132.6	133.1	134.5	135.5	136.5
Adj EPS (p), diluted	**21.1**	**24.9**	**29.6**	**32.6**	**35.0**	**36.9**
Total DPS (p)	14.0	14.0	14.5	15.0	15.5	16.0

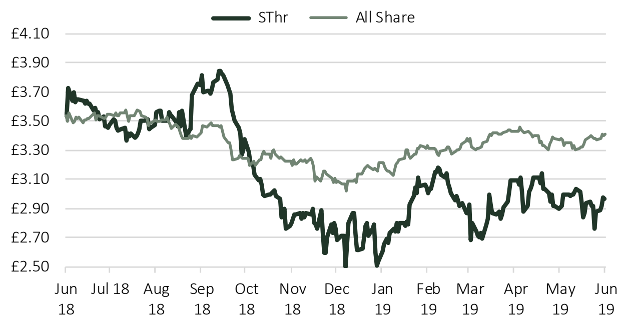
CASH FLOW

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)	(14.6)	(15.8)
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**	**40.1**	**52.7**
Capex	(6.1)	(5.8)	(5.2)	(6.0)	(6.0)	(6.0)
Free Cashflow	**27.1**	**23.1**	**10.0**	**33.9**	**34.1**	**46.7**
Dividends	(18.0)	(18.0)	(18.0)	(19.3)	(20.2)	(21.0)
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**	**10.9**	**22.7**
Net Cash (Debt)	**10.0**	**5.6**	**(4.5)**	**7.1**	**18.0**	**40.7**

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	18.0	40.7
Net Assets	**75.7**	**80.7**	**101.3**	**129.5**	**158.7**	**190.1**

PRICE CHART - 1 YEAR ABSOLUTE vs FTSE ALL SHARE



Source: FactSet

SHAREHOLDERS

	% of ord. Share capital
JO Hambro Cap Mgmt	11.5%
SThree Founders	8.6%
Franklin Templeton	5.5%
Harris Assoc	5.4%
Allianz Global	4.9%
M&G	4.7%
JPMorgan AM	4.3%
	44.9%

Announcements

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

RATIOS

	2017	2018	2019E	2020E	2021E
RoE	41.0%	39.0%	33.9%	29.9%	26.5%
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%	28.2%	23.1%
Op Cash % EBITA	89.2%	55.8%	91.8%	87.0%	102.4%
Net Debt / EBITDA	0.2x	0.1x	-0.1x	0.1x	0.3x

VALUATION

Fiscal	2017	2018	2019E	2020E	2021E
P/E	11.9x	10.0x	9.1x	8.5x	8.0x
EV/EBITDA	7.7x	6.5x	6.0x	5.6x	5.3x
Div Yield	4.7%	4.9%	5.1%	5.2%	5.4%
FCF Yield	5.9%	2.6%	8.7%	8.7%	12.0%
Net Fees growth	11.2%	11.6%	7.1%	5.3%	4.7%
EPS growth	18.4%	18.9%	9.9%	7.3%	5.6%
DPS growth	0.0%	3.6%	3.4%	3.3%	3.2%

REGULATORY DISCLOSURES

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