SThree PLC

STEM | Small Cap | Support Services | 351p | £466m

H1 results – No change to outlook, best margins in the peer group

1 Year Chart

H1 results provide more detail, context and a more up to date take on the trading environment following the Q2 trading update. The results lay clear the extent to which SThree has been able to protect margins (unlike others in the peer group) despite the significant investment in the Technology Improvement Programme, which itself lays the ground for future margin outperformance. Current trading continues to be tricky, although there are some green shoots visible as we enter H2. Following the Q2 update we made a number of estimate revisions. Following the H1 results we see no reason to make any further changes. The Q3 update, due in September, will confirm the extent of any stabilization / recovery.

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 current EBIT margins combined with a clearly more resilient net fee line continues to feel more than a little anomalous. Visibility over the potential impact of the Technology Improvement Programme continues to grow and underpins the potential for SThree to become the structural margin leader in the peer group over the medium and longer term. This potential is not captured in the current valuation, which paints SThree as a laggard rather than the leader all the evidence points to. At the very least, we now expect SThree to end 2023 with the second largest net cash position in the peer group.

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

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

25th July 2023

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- **Solid H1:** Overall, H1 net fees came in -2% YoY on constant currency basis and +3% post FX. As previously guided, EBIT margins were down YoY to 18.3%, albeit against exceptionally tough H1 FY22 comps and after £2.6m of technology investment spend. The interim dividend has been maintained at 5.0p and net cash of £72.4m underscores the strength of the balance sheet.
- **Trading outlook:** The tone of the trading outlook commentary has begun to improve although it is clear the broader macro environment remains volatile for recruitment companies in general. Contract extensions and renewals have been a source of strength for SThree but the company is now pointing to "modestly" improving new business levels and an improving trend through Q2 and into Q3.
- **No estimate changes.** Taking the outlook commentary into account and after digesting the details around H1 margins, we are not minded to make any further changes to our estimates following the single digit reductions we made post the Q2 trading update. All eyes will be on the Q3 update, where we will see any further confirmations around improvements in the new business environment.

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	11.4	3.1
FY 2022A	430.6	77.0	39.9	16.0	65.4	8.8	4.5
FY 2023E	*418.4*	*71.6*	*38.1*	*15.2*	*93.1*	*9.2*	*4.3*
FY 2024E	*448.4*	*79.9*	*41.5*	*16.6*	*96.4*	*8.4*	*4.7*
FY 2025E	*473.7*	*92.9*	*47.6*	*19.0*	*114.6*	*7.4*	*5.4*

Source: Radnor Capital Partners

H1 results – Key highlights

SThree have announced results for the six months ended May 2023. Key headlines are:

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

- H1 EBIT came in at **£38.1m** (down 15% on H1 FY22), delivering a margin of **18.3%** (H1 FY22: 22.0%). We discuss the margin performance in H1 in more detail below but H1 margins were impacted by the planned £2.6m of technology spend. EBIT margins pre- IT spend would have been 19.5%.

- Contractor Order Book (the best measure for forward visibility) ended H1 **flat YoY.** The group now has visibility over c.75% 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 with Life Sciences the largest driver here -43% as the sector continued to suffer from a post pandemic pullback and tough comparatives. The 10% decline in Permanent headcount was also a significant contributor to the net fee decline as the group continued to prioritise investment towards Contract.

- 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.

- Further down the P&L, EPS came in at 21.0p (down 13% from H1 FY22) while the interim dividend has been maintained at 5.0p.

- H1 closing net cash of **£72.4m**, +50% YoY, including £10m of shares bought back to settle EBT liabilities and the capex element of the IT spend (c.£2m.)

The net fee performance is not new news, having been broken down in detail at the earlier Q2 trading update. However, the strength of SThree's margin performance and the maintaining of the interim dividend (and the signal this sends) are the main "new" take aways from these results.

Outlook Commentary

The outlook commentary in these results remains largely unchanged from the Q2 update. The macro backdrop is challenging for all recruiters, especially in the permanent space, with underlying client activity moderating through the course of the year. Candidate wage inflation is a partial offset.

However, SThree's contract focus is a materially positive differentiation point here with candidate and skills scarcity driving a better than originally expected contract extension and renewal performance. We can see this at the basic headline variance between Contract net fees (+3% YoY in H1) vs Permanent (-19% YoY in H1).

SThree has provided a more detailed narrative around Q2 trading patterns and exit momentum. The picture here, at best is of the beginning of a recovery trend in new business levels, and at worst a visible moderation of year on year declines. The company has been at pains to be cautious in their tone and not to be seen to be calling a turn too prematurely. Nonetheless the outlook feels less negative than it did earlier in the half.

At the time of Q2 update, we made a number of revisions to our estimates, which resulted in a 6% reduction in our FY23E net fee expectations, a 12% reduction in our PBT estimate and a 9% reduction in our EPS estimate. A natural economic function of SThree's contract focused business model is the release of working capital as net fee growth slows. At the Q2 update, we upgraded our net cash expectations by 32% to £93.1m.

Following the greater detail in the H1 results and the up to date trading commentary and outlook, we are not minded to make any further revisions to our estimates at this point. The next expected news-flow will be the Q3 trading update expected in September.

SThree compared to the UK peer group

In what are undoubtedly tricky trading conditions, the dual aspect of SThree's business model continues to stand out relative to UK listed peers.

→ **Contract extensions and renewals** have proven resilient with performance here at least in-line, if not marginally better than initial expectations.

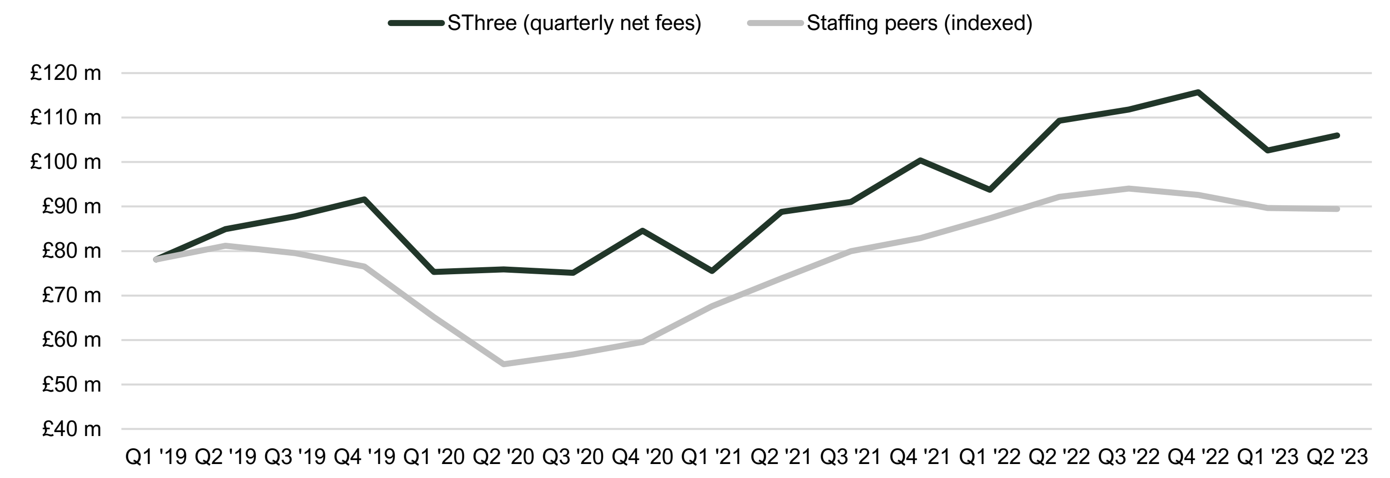
→ **New business** has been more challenging, a point that the company has been explicit around for at least the last two quarters. However, initial effects had varied across the group, becoming more uniform as the year has progressed.

We have highlighted before this interplay between the "installed" contractor base and the new business pipeline as a feature of SThree marking it out from UK listed peers; none of whom offer the same Contract weighting and the net fee duration and visibility this implies.

The key point here is not that SThree is immune from cyclical pressures that affect all recruitment businesses; but that SThree's net fee and margin curves should be flatter and less volatile than others. This comparison has been made even starker by the extent of recent downgrades across the peer group over the course of the last year.

In Figure 1, we show the quarterly net fee progression for SThree. We also show the UK peer group net fee growth (on a reported and aggregated basis and calendarising for Hays) rebased against SThree. This shows clearly how, even looking back to a pre-pandemic starting point, SThree has maintained its outperformance of the peer group in terms of net fee growth even through the pandemic recovery period when the Permanent recovery curve was at its steepest.

Figure 1: SThree vs Peers – SThree Net Fees from Q1 2019 with UK Peer Group rebased to SThree



Source: Radnor

Below in Figures 2 and 3, 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 2: SThree vs Peers – Consensus Net Fees

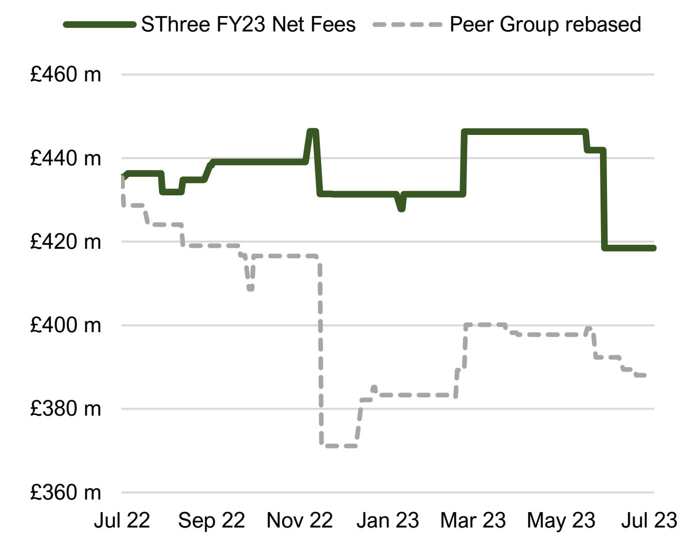
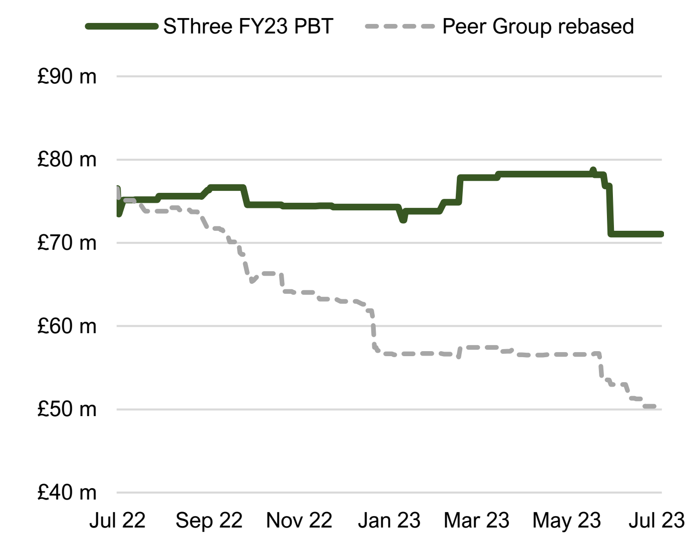


Figure 3: SThree vs Peers – Consensus PBT



Source: Radnor, FactSet

What does this tell us?

- Since June 2022, the peer group has seen consensus FY23 expectations for Net Fees and PBT downgraded in aggregate by **-11%** and **-34%** respectively.

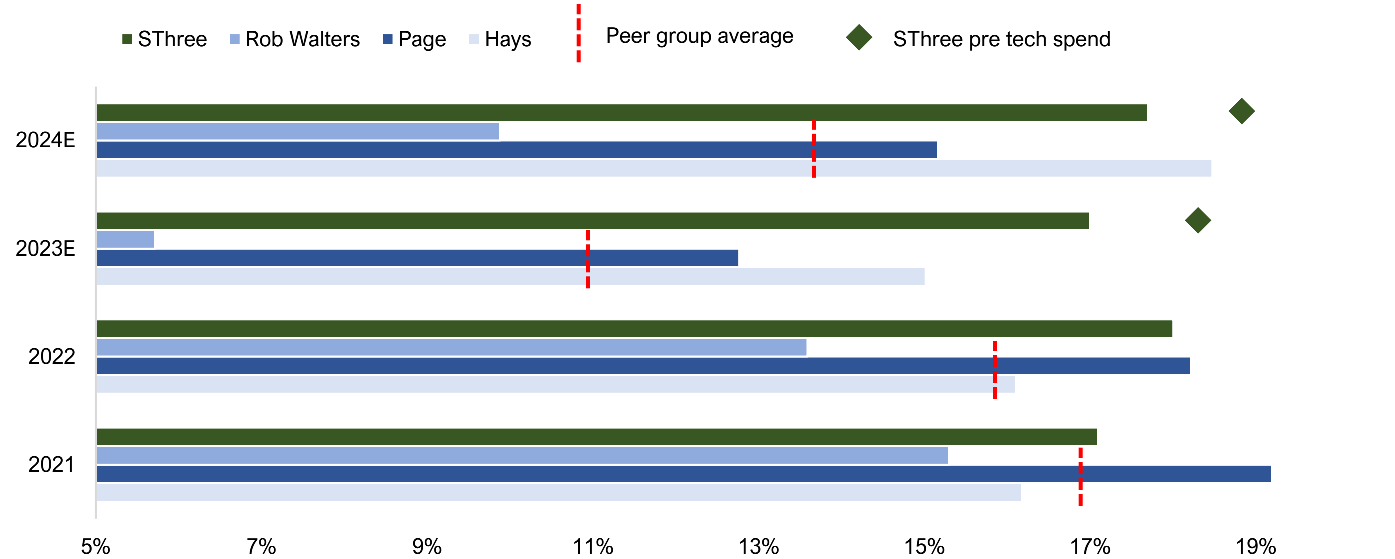
- By contrast, SThree has seen consensus FY23 Net Fees and PBT reduce by **-4%** and **-7%** respectively.

Although, SThree has clearly outperformed the UK peer group in terms of net fee growth since prior to the pandemic and is currently showing a greater degree of net fee resilience, the clearest point of differentiation lies in operating margins.

We believe the received wisdom in the market is that Permanent placement is a structurally higher margin activity than longer duration Contract. The spot nature of Perm business and the high operating leverage implied are the cornerstones of this long held perception.

Yet, SThree has shown a degree of margin outperformance since 2020 that challenges this received wisdom. In Figure 4 below, we show EBITA margins for the peer group for 2021, through to 2024 (for Hays we show the June 2024 and 2025 consensus EBIT margins). We also show the peer group average and also SThree on a pre technology spend basis.

Figure 4: SThree vs Peers – Direct EBIT margin comparison 2021 - 2024



Source: Radnor, FactSet

- 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 2023 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. If successful, this would leave SThree as the structural margin leader in the peer group.

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 5 & 6 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 5: 1 Year prospective PE multiple

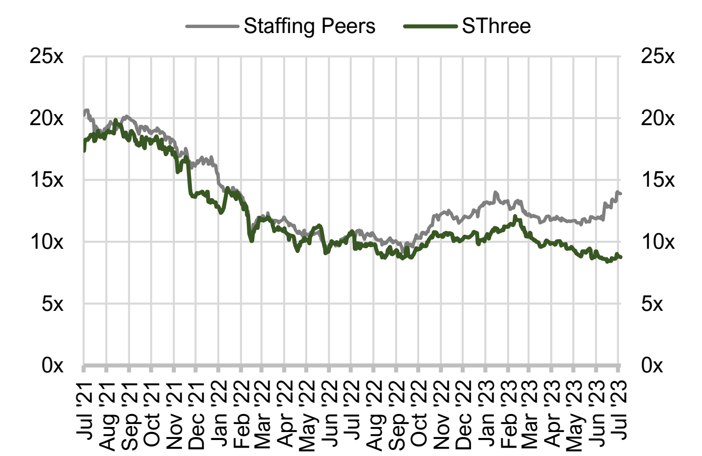
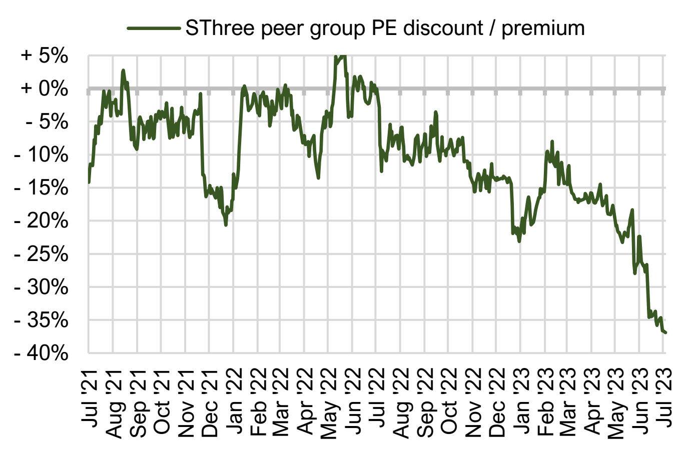


Figure 6: SThree PE discount / premium



Source: FactSet, Radnor

SThree PLC

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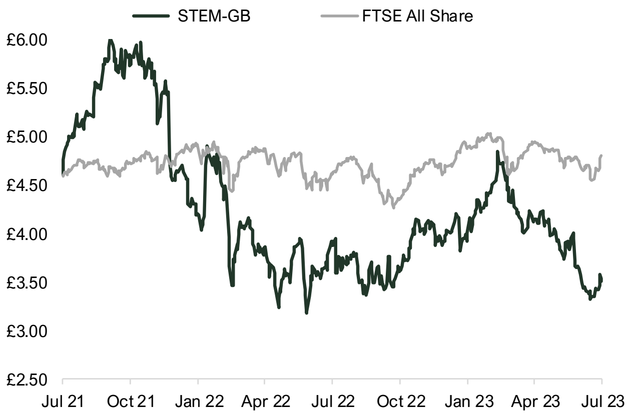
Price (p):	351 p
Market Cap:	466 m
EV:	400 m

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
25 July 2023	H1 results
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

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	11.4x	8.8x	9.2x	8.4x	7.4x
EV/EBITDA	5.1x	4.2x	4.4x	4.1x	3.6x
Div Yield	3.1%	4.5%	4.3%	4.7%	5.4%
FCF Yield	8.5%	10.3%	18.1%	11.7%	16.0%
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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