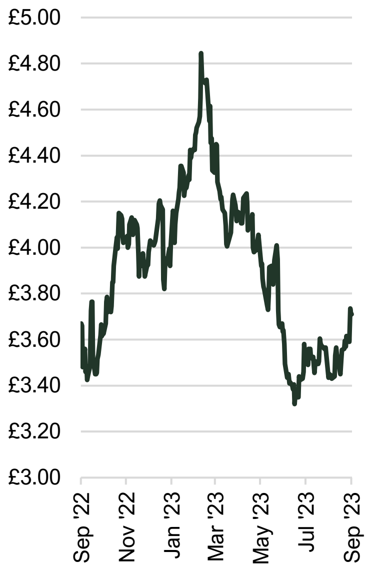
SThree PLC

STEM | Small Cap | Support Services | 371p | £488m

Q3 update – Early signs of improvement, in-line outlook

1 Year Chart



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

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

The trading backdrop for SThree through the last three quarters has been consistent; a challenging backdrop for new business, offset by resilience in contract extensions and renewals for the contractor order book. Q3 paints a broadly similar picture although the tone of commentary around new business is more optimistic and we can now see a clear sequential net fee improvement between Q2 and Q3 when we adjust for the offices restructured late last year (Ireland, Hong Kong and Singapore).

SThree is the first of the peer group to report and we await the others with interest. A feature of 2023, yet to be recognized by the market, has been SThree's overall margin and net fee resilience. Over the last 12 months, we have seen average PBT expectations for the peer group decline by -32%, compared to -5% for SThree.

When it comes to operating margins, SThree will be the clear peer group leader in FY23, despite the investment in the Technology Improvement Programme, which itself is intended to deliver a structural margin improvement once fully rolled out. We believe SThree offers the highest quality of earnings in the peer group and should trade at a valuation premium. The support of a strong balance sheet alongside significant margin upside potential is, in our view, not captured in the current valuation.

- **Net Fees:** Headline Q3 net fees came in -7% YoY on a constant currency basis, in-line with Q2. Adjusting for restructured businesses, Q3 net fees were -5% vs -6% in Q2. Headline Contract net fees were flat YoY in Q3 vs a -31% decline in Permanent net fees, partly driven by a 21% decline in average Perm headcount. New business activity has actually improved sequentially vs Q2 whilst contract extensions and renewals remained solid. Overall, the contractor order book was flat YoY with SThree now enjoying 90%+ visibility over full year net fees.
- **Productivity:** Underpinning the SThree margin resilience story, Q3 productivity only declined -1% YoY but still remains +38% ahead of pre-pandemic levels. Some degree of productivity reversion has been clearly flagged by the company for some time now. It is worth noting that structural productivity improvements are a key ambition sitting behind the Technology Improvement Programme.
- **Estimate changes.** We note the in-line trading commentary and are therefore not making any changes to our FY23 estimates. We are taking a slightly more cautious view on the outlook for the Perm business, in particular, as SThree continues to weight its investment towards Contract. We are reducing our FY24 net fee / PBT estimate by 3% but leave our margin estimate unchanged as we continue to look for YoY margin improvement in FY24.

25th September 2023

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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	12.0	3.0
FY 2022A	430.6	77.0	39.9	16.0	65.4	9.3	4.3
FY 2023E	*418.4*	*71.6*	*38.1*	*15.2*	*93.1*	*9.7*	*4.1*
FY 2024E	*433.7*	*77.3*	*40.2*	*16.1*	*98.9*	*9.2*	*4.3*
FY 2025E	*456.1*	*89.4*	*45.9*	*18.3*	*116.6*	*8.1*	*4.9*

Source: Radnor Capital Partners

Q3 trading update – Key highlights

- Headline Q3 net fees **£103.0m, -7% on a constant currency** basis.

- Adjusting for business restructured in Q4 FY22 (Ireland, Singapore and Hong Kong), underlying net fees in Q3 were down -5% YoY vs a -6% YoY decline in Q2.

- Contractor Order Book (the best measure for forward visibility) ended Q3 **flat YoY**, similar to H1**.** SThree now has visibility over 90% plus of FY23E net fees.

- The COB performance was driven by a sequential improvement in Q3 new business placements combined with "robust" contract and extensions performance. This theme of new business variability but resilience in the contractor order book has been a key feature of FY23.

- **Q3 Contract** net fees (**84%** of the group total) were **flat YoY**, an improvement on the -1% YoY in Q2. Adjusting for the restructured businesses, contract net fees were actually positive (+1% YoY) in Q3.

  By region, we can see a broad range of outcomes for Q3 contract net fees. We do note that three of the group's key regions actually delivered positive YoY contract net fee growth. By skill, Engineering was the best performer (+21% YoY), underpinning the Netherlands performance, while Life Sciences continued to be weak (-15% YoY), impacting the US and DACH in particular.

  → DACH -3%

  → Netherlands region +10%

  → Rest of Europe +4%

  → USA -7%

  → Middle East & Asia +3%

- **Q3 Permanent** net fees (**16%** of the group total) declined -31% YoY. In a similar fashion to Q2, Perm net fees were down in all the group's key markets. The driver here is a clear combination of a challenging backdrop for Perm recruitment more generally, combined with SThree's deliberate decision to target investment towards the most valuable Contract markets. Perm headcount reduced -21% YoY in Q3.

- Q3 period end **headcount** was down -14% vs Q4 2022 although this includes the restructuring of a number of smaller offices (underlying headcount was -12% YoY). Like for like quarter end headcount was down -12%. Permanent headcount saw the biggest decline with average headcount -21%. 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 -1% although this remains 38% ahead of pre-Covid productivity levels.

- Q3 closing net cash of **£83m**, +46% YoY and +15% since H1 FY23 (net cash £72.4m)

Changes to Radnor estimates

SThree has confirmed that FY23 guidance remains unchanged. The sequential improvement in new business activity coupled with a good performance for contract extensions and renewals provides good visibility over the full year outcome. We are therefore leaving our full year FY23 estimates unchanged.

Looking out to FY24 and beyond, the clarity of outlook remains unclear. We note the improvement in new business activity but a single quarter is not a reliable indicator. We also note the accelerating pace of the planned transition away from Permanent. The net result is a 3% reduction in our overall net fee estimate. We now look for +5% YoY growth in Contract net fees and a 1% decline in Permanent.

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**	**1,591.0**	**1,705.0**	**1591.0**	**1,649.0**	**-**	***- 3%***
DACH	148.9	142.4	152.3	142.4	147.6	-	*- 3%*
Netherlands	75.7	79.1	85.3	79.1	83.0	-	*- 3%*
Rest of Europe	73.1	70.5	74.0	70.5	72.5	-	*- 2%*
USA	111.5	105.6	115.1	105.6	109.0	-	*- 5%*
ME & Asia	21.4	20.8	21.8	20.8	21.6	-	*- 1%*
Group Net Fees	**430.6**	**418.4**	**448.5**	**418.4**	**433.7**	**-**	***- 3%***
EBITA	**77.6**	**71.1**	**79.4**	**71.1**	**76.8**	**-**	***- 3%***
- margin %	*18.0%*	*17.0%*	*17.7%*	*17.0%*	*17.7%*		
Adj. PBT	**77.0**	**71.6**	**79.9**	**71.6**	**77.3**	**-**	***- 3%***
Adj. EPS (p)	**39.9**	**38.1**	**41.5**	**38.1**	**40.2**	**-**	***- 3%***
Dividend (p)	16.0	15.2	16.6	15.2	16.1	-	*- 3%*
Net Cash (Debt)	**65.4**	**93.1**	**96.4**	**93.1**	**98.9**	**-**	***+ 3%***

Source: Radnor

However, productivity performance continues to be impressive and we are leaving our margin estimates unchanged. We continue to look for a 70 basis point improvement in headline margins in FY24 despite the full annualisation of the Technology Improvement Programme costs.

- It is important to note here that our 17% EBIT margin estimate in FY23 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 FY23 EBIT margins would be closer to 18.4%, which remain ahead of FY22 and FY21.

- We also note the announcement by Page of their new 2030 ambitions, which make for an interesting comparison with SThree. Here we see Page looking to improve their EBIT margin to "at least" 20% by 2030. Underpinning this ambition is an implied seven year net fee CAGR of between 9% and 10% per annum.

- We currently estimate SThree delivering EBIT margins close to this level by 2025 and that is before the full effect of the TIP coming into play. Our clear sense is that if the TIP delivers anything near its full potential in terms of embedding productivity gains, then SThree will be delivering EBIT margins well in excess of the Page ambition without the same reliance on what appear to be aggressive net fee growth ambitions. Page have provided detail over c.£20m of ongoing cost efficiencies but we see the largest driver of their margin expansion coming from an expectation around sustained net fee growth. Given their reliance on Perm and near-term macro challenges, a seven year ambition feels somewhat ambitious.

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.

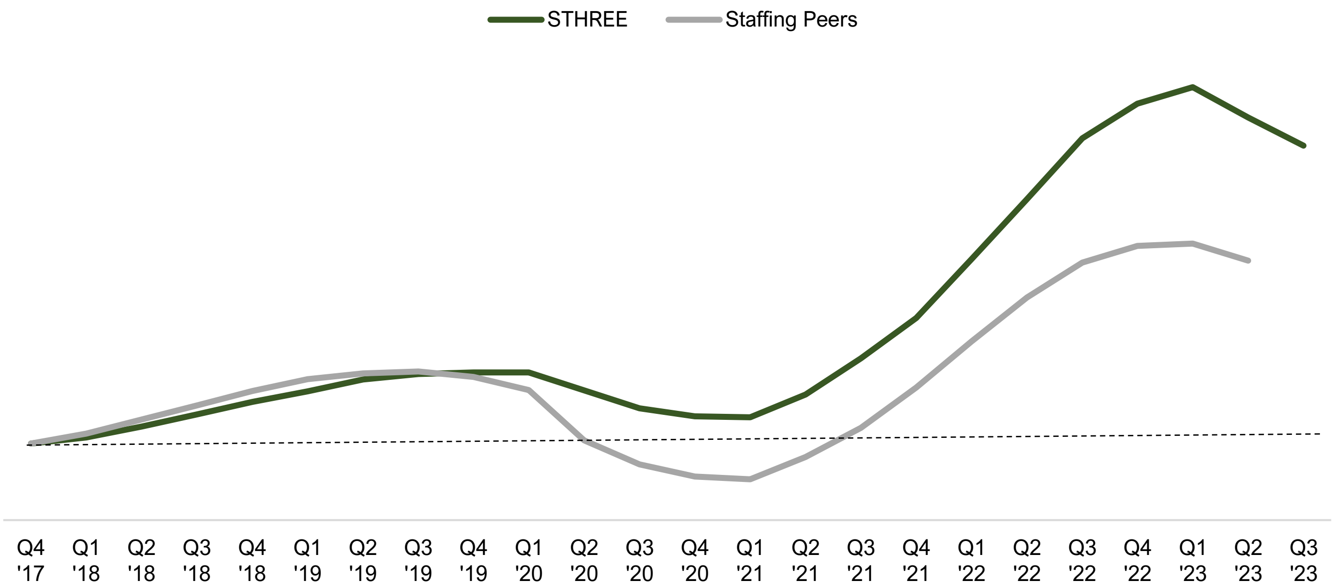
→ **New business** has been more variable, a point that the company has been explicit around for at least the last three quarters. Q3 did see a distinct improvement over Q2 but it remains early to call a positive trend emerging.

We have highlighted in previous research notes that this interplay between the existing 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. The extent of downgrades across the peer group bear this out.

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

Figure 2: SThree vs Peers – Quarterly LFL net fee YoY growth indexed back to 100 in Q4 2017



Source: Radnor

Below in Figures 3 we show the evolution of one year forecast consensus estimates for PBT for SThree and the peer group, rebased to SThree, over the last 12 months. In Figure 4 we show the evolution of consensus FY1 EBIT margins for each member of the peer group.

Figure 3: SThree vs Peers – Consensus PBT

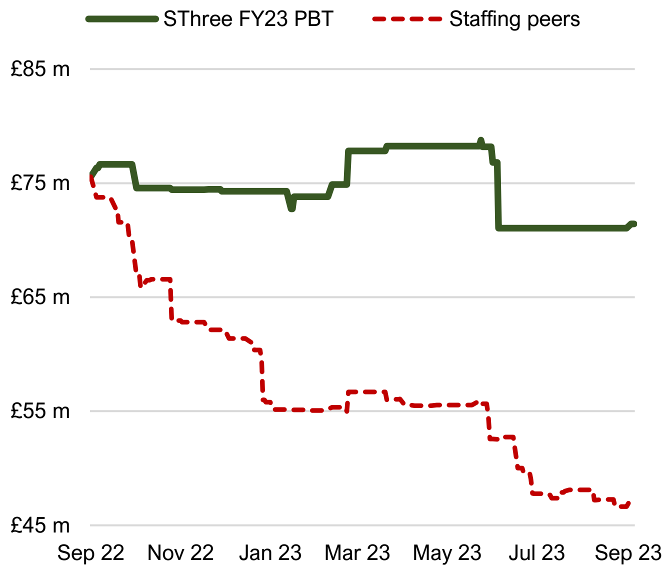
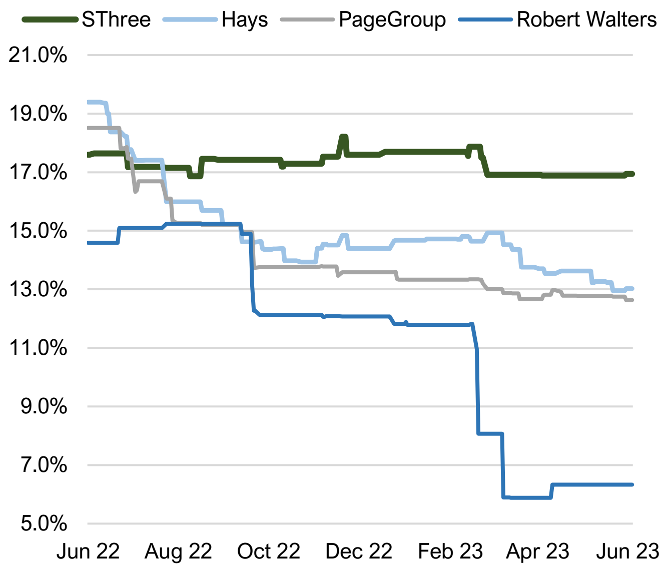


Figure 4: SThree vs Peers – Consensus EBIT margin



Source: Radnor, FactSet

What does this tell us?

- Over the last year, the peer group has seen FY23 PBT consensus expectations downgraded in aggregate by **-32%.**
- By contrast, SThree has seen FY23 PBT consensus expectations change decline by **-5%.**

We can see from the above that:

- Market consensus has seen SThree delivering the **highest** EBIT margins in the peer group since August 2022;
- SThree margin expectations have **declined** only **130 basis points** from their peak, compared to **640 basis points** for Hays**, 590 basis points** for PageGroup and **890 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 this clear net fee and margin outperformance, the valuation gap between SThree and its peers has remained significant, although it has narrowed more recently.

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

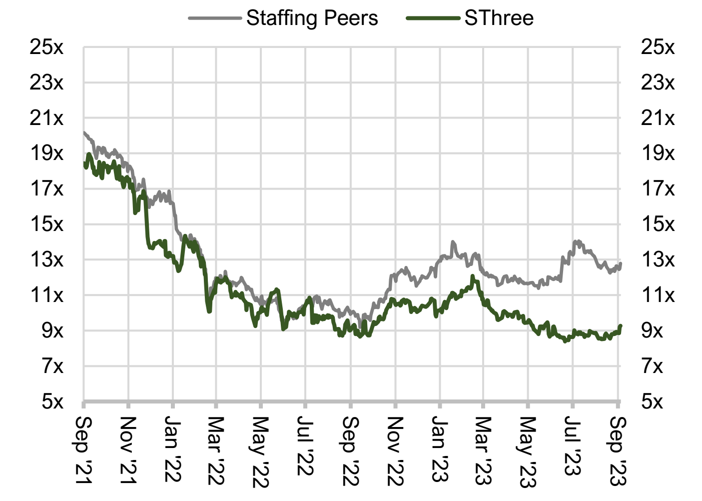
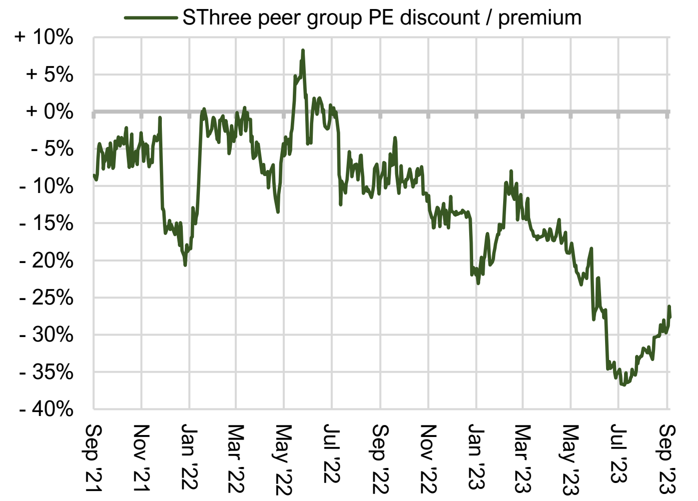


Figure 6: SThree PE discount / premium



Source: FactSet, Radnor

SThree PLC

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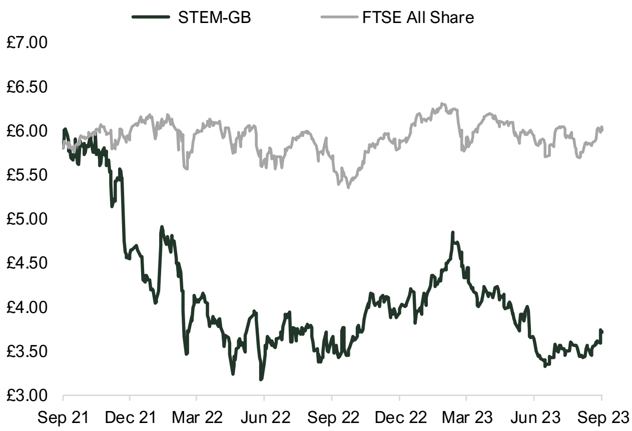
Price (p):	**371 p**
Market Cap:	488 m
EV:	423 m

PROFIT & LOSS

Year to 31 November, £m	2021	2022	2023E	2024E	2025E
Group Sales	**1,330.7**	**1,639.4**	**1,591.0**	**1,649.0**	**1,734.3**
DACH	*129.4*	*148.9*	*142.4*	*147.6*	*155.4*
Netherlands	*57.5*	*75.7*	*79.1*	*83.0*	*87.9*
Rest of Europe	*64.5*	*73.1*	*70.5*	*72.5*	*74.8*
USA	*89.3*	*111.5*	*105.6*	*109.0*	*115.4*
ME & Asia	*15.0*	*21.4*	*20.8*	*21.6*	*22.7*
Group Net Fees	**355.7**	**430.6**	**418.4**	**433.7**	**456.1**
Op. Exp.	(277.2)	(334.2)	(328.1)	(337.4)	(347.3)
EBITDA	**78.5**	**96.5**	**90.3**	**96.3**	**108.8**
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**	**76.8**	**88.9**
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**	**77.3**	**89.4**
Non Operating Items	-	-	-	-	-
Other Financial Items	-	-	-	-	-
PBT - IFRS	**60.0**	**77.0**	**71.6**	**77.3**	**89.4**
Tax - Adjusted	(17.9)	(22.8)	(20.4)	(22.4)	(26.4)
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**	**40.2**	**45.9**
Total DPS (p)	11.0	16.0	15.2	16.1	18.3

PRICE CHART - 2 YEAR ABSOLUTE vs FTSE ALL SHARE



Source: FactSet

SHAREHOLDERS

	% of ord. Share capital
Kempen Cap Mgmt	11.4%
JO Hambro	6.5%
JPMorgan AM	5.6%
Littlejohn	5.0%
BlackRock	4.9%
Allianz	4.7%
Polar Capital	3.8%
	41.9%

CASH FLOW

Year to 31 November, £m	2021	2022	2023E	2024E	2025E
EBITDA	78.5	96.5	90.3	96.3	108.8
Working Capital	(26.6)	(38.6)	13.4	(18.1)	(18.2)
Provisions / Exceptionals	2.5	6.5	-	-	-
Gross Op Cashflow	**54.5**	**64.3**	**103.7**	**78.2**	**90.5**
Cash Tax	(16.8)	(18.9)	(22.8)	(20.4)	(22.4)
Cash Intererest	(0.9)	(0.7)	0.5	0.5	0.5
Net Op Cashflow	**36.8**	**44.8**	**81.4**	**58.3**	**68.6**
Capex	(2.6)	(3.7)	(9.0)	(9.0)	(6.0)
Free Cashflow	**34.2**	**41.1**	**72.4**	**49.3**	**62.6**
Dividends	(6.7)	(14.8)	(21.7)	(20.5)	(21.9)
Acquisitions & Inv.	-	-	-	-	-
Other Non Operating	(12.5)	(13.7)	(13.7)	(13.7)	-
Net Cashflow	**15.0**	**12.6**	**37.0**	**15.1**	**40.7**
Net Cash (Debt)	**57.4**	**65.4**	**93.1**	**98.9**	**116.6**

Announcements

Date	Event
19 September 2023	Q3 update
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

RATIOS

	2021	2022	2023E	2024E	2025E
RoE	26.6%	27.1%	24.2%	23.5%	23.4%
RoCE	60.4%	57.4%	59.9%	57.1%	58.0%
Asset Turnover (x)	0.1x	0.1x	0.1x	0.1x	0.1x
NWC % Revenue	6.0%	7.4%	6.7%	7.6%	8.3%
Op Cash % EBITA	89.6%	83.0%	145.8%	101.9%	101.8%
Net Debt / EBITDA	-0.7x	-0.7x	-1.0x	-1.0x	-1.1x

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	369.4	391.9
Current Liabilities	(218.4)	(243.2)	(242.7)	(244.0)	(248.4)
Net Current Assets	**79.6**	**120.7**	**107.3**	**125.3**	**143.6**
Long Term Liabilities	(24.0)	(26.4)	(26.4)	(26.4)	(26.4)
Net Cash (Debt)	57.4	65.4	93.1	98.9	116.6
Net Assets	**158.1**	**200.4**	**211.9**	**233.3**	**270.0**

VALUATION

Fiscal	2021	2022	2023E	2024E	2025E
P/E	12.0x	9.3x	9.7x	9.2x	8.1x
EV/EBITDA	5.4x	4.4x	4.7x	4.4x	3.9x
Div Yield	3.0%	4.3%	4.1%	4.3%	4.9%
FCF Yield	8.1%	9.7%	17.1%	11.7%	14.8%
Net Fees growth	15.3%	21.1%	-2.8%	3.6%	5.2%
EPS growth	128.6%	29.5%	-4.6%	5.5%	14.1%
DPS growth	120.0%	45.1%	-4.6%	5.5%	14.1%

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