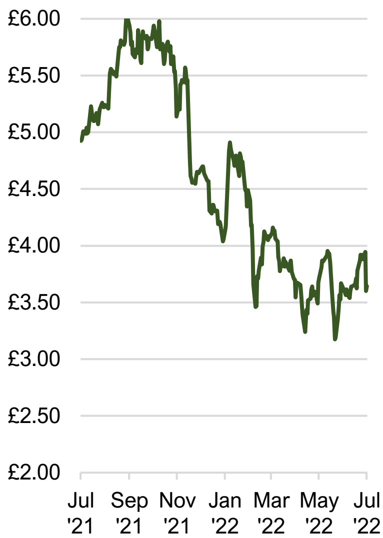
SThree PLC

STEM | Small Cap | Support Services | 364p | £484m

H1 results – Strong H1 momentum, exceptional margins will revert in H2

1 Year Chart



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SThree's H1 results had been flagged at the Q2 update; with +20% net fee growth delivered across all the group's key regions. However, the H1 results were especially notable for the 22% EBIT margin, as the group benefits from heightened productivity.

SThree has been consistent in guiding towards a lower H2 EBIT margin, driven by the initial cost impact from the well flagged investment programme and the full cost effects of headcount investment dampening productivity. We still expect FY22 margins (pre investment costs) to show healthy progression vs FY21. Overall, we are keeping our FY22 net fee and PBT estimates unchanged (although tweaking up EPS and dividend) but continue to see risks very much on the upside. We await the Q3 trading update in September.

We note that the macro factors that have so spooked the market have largely been in place since the start of the year but have not yet materialised in what is assumed to be a highly cyclically exposed peer group. Secondly, SThree materially outperformed the peer group through the last external shock and every indication is that this will be repeated. Against this context, a sub 10x PE and c.4% yield looks very attractive.

- **Positive momentum maintained:** SThree has reported +25% YoY net fee growth for H1 FY22, +23% YoY for Q2. All the key geographical markets delivered constant currency growth in excess of 20% with Contract (+30% YoY) continuing to outstrip Perm (+11% YoY). ECM continues grow as a proportion of the group.
- **Contractor order book strength underpins H2:** Unlike many of its peers, SThree's contract focus does provide good forward visibility into H2. The +35% contractor order book growth for H1 is highly impressive and underscores the high levels of client and candidate activity across the group. There is little indication at the moment of any tangible slowdown in the group's core markets.
- **Productivity gains continue in FY22 but will begin to revert:** Alongside net fee growth, productivity gains have been the standout feature of the last 18 months. SThree has consistently flagged headcount and internal systems investment, both of which will impact H2 margins. We continue to expect SThree (pre c.£8m investment spend) to deliver further underlying margins vs FY21 consistent with ambitions to deliver sustainable margins in excess of 21%.
- **Estimate upgrades.** We maintain our net fee and PBT expectations, although we are tweaking upwards our EPS and dividend expectations (+6% / +15% respectively) to reflect a lower tax outlook. If Q3 net fee growth is maintained anywhere near Q2's +23% then further upgrades will be likely.

November, £m	Net Fees	PBT adj	EPS (p)	Div (p)	Net Cash	Fiscal PER x	Yield %
FY 2020A	308.6	30.1	13.5	5.0	49.9	27.0	1.4
FY 2021A	355.7	60.0	30.8	11.0	57.5	11.8	3.0
FY 2022E	*412.3*	*71.5*	*37.6*	*15.0*	*56.1*	*9.7*	*4.1*
FY 2023E	*442.1*	*78.9*	*40.7*	*16.3*	*70.2*	*8.9*	*4.5*
FY 2023E	*476.7*	*88.5*	*44.9*	*17.3*	*81.1*	*8.1*	*4.7*

Source: Radnor Capital Partners

H1 Results – Key highlights

- H1 FY22 reported net fees **£203.1m (+25% YoY constant currency)** with Q2 net fees +23% YoY. This is a record result for the group.

- The Contractor Order Book (the single best measure for forward visibility) ended Q2 **+35% YoY**

- EBIT came in at **£44.6m (+62% like for like, YoY)** with an EBIT margin (based on net fees) of 22.0% (+ 4.8% vs H1 FY21).

- H1 productivity improved by a further 14% in H1, helping to drive the exceptional H1 margin performance. Guidance has been maintained that this level of productivity is likely to fall in H2 as headcount growth begins to wash through.

- The effective tax rate in H1 was 28%, which delivered a H1 EPS of **24.1p**, **+71%** like for like, YoY.

- The interim dividend has been set at **5.0p, +67% YoY** and the full year dividend guidance has been maintained with a cover range of 2.5x to 3.0x. Historically, SThree has followed a one third / two third dividend split and this would imply 15p for the full year, which would equate to 2.5x cover on our estimates.

- Net cash at the end of May 2022 of £48.4m, in line with May 2021 and down from the £57.5m reported at the last year end. SThree is a net absorber of working capital as underlying net fee income grows, which is a natural function of SThree's contract economics and a key competitive barrier to entry. SThree also bought £10m of shares into treasury in order to satisfy EBT share awards.

- By region, on a constant currency basis and YoY:

  - **DACH** (35% of group net fees) +24% for H1, +23% in Q2

  - **EMEA** (37% of group net fees) +28% for H1, +26% in Q2

  - **USA** (25% of group net fees) +21% for H1, +16% in Q2

  - **APAC** (3% of group net fees) +47% for H1, +32% in Q2

- By business type:

  - **Contract** (77% of group net fees) +30% for H1, +29% in Q2

  - **Permanent** (23% of group net fees) +11% for H1. +5% in Q2

Critically for SThree, all of the group's key regions and also all of the Top 5 individual markets delivered net fee growth greater than 20% in H1.

Within the Contract business, the Employed Contractor Model "ECM", continued to grow strongly (+37% YoY) and now represents 33% of net fees. ECM is a more complex client solution which is higher margin (positive structural driver behind sustained productivity improvements). ECM is the dominant staffing model in the US and continues to gain traction in Europe. SThree's combination of STEM focus and ECM offering is a point of competitive differentiation compared to peers.

We also note the performance of the UK, which for a number of years has been a challenging market for SThree. Although four quarters does not a summer make, this now marks the fourth consecutive quarter of positive YoY growth (+28% in Q2 and +29% in Q1), which does suggest that a corner may have been turned following previous restructuring and management changes. The UK remains well outside the Top 3 largest territories for SThree (it is the 4th largest and delivered £22.2m of net fees in H1).

In Figure 2 and 3 below, we show the quarterly net fee track record for SThree and the UK Staffing Peer Group. Figure 1 shows the absolute YoY growth comparison since Q1 2016. Figure 2 shows the Peer Group rebased against SThree since Q1 2019. Figure 1 demonstrate SThree's lower net fee volatility while Figure 2 shows the extent to which SThree has actually outperformed the peer group in absolute net fee growth (despite the peer group being thought of as natural outperformers in cyclical recovery periods).

Figure 1: SThree net fee growth vs Peer Group

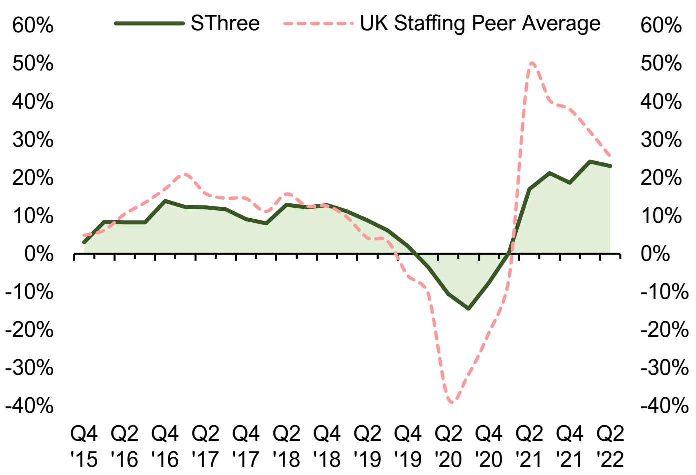
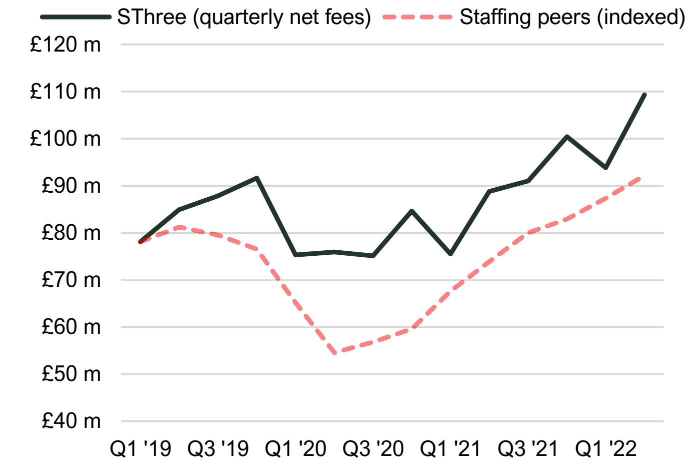


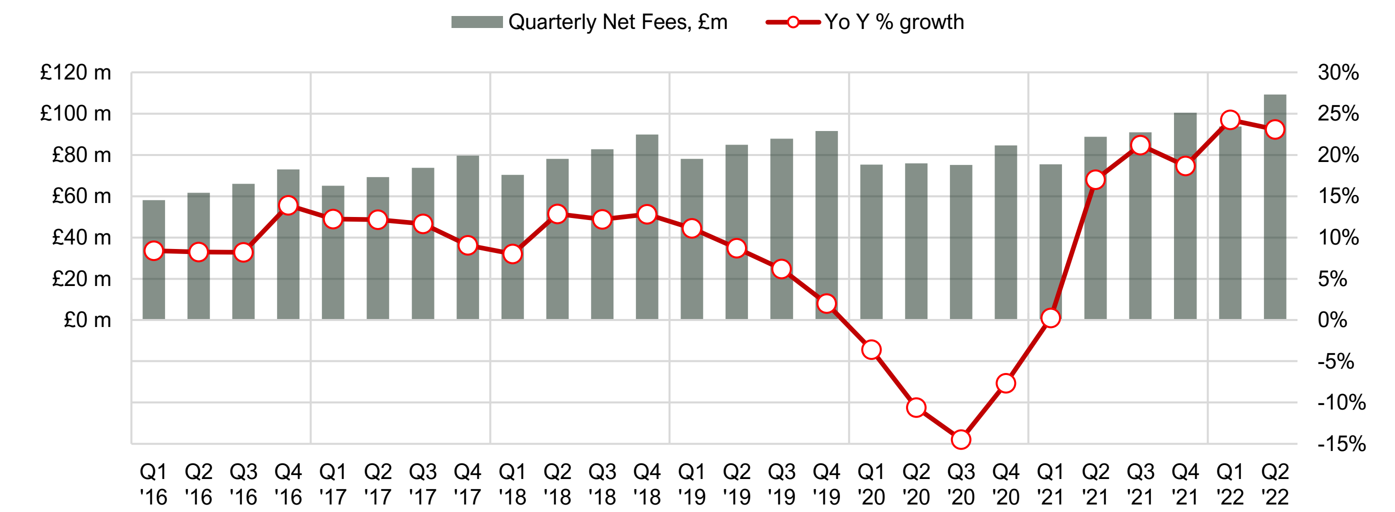
Figure 2: Peer Group indexed back to SThree



Source: FactSet, Radnor

In Figure 3 below, we show SThree in isolation over a longer timeframe (Q1 2016). We can see from here that Q2 2022 was a record quarter for the group in terms of net fees with Q4 2021 the previous peak. Q4 is traditionally the strongest quarter for the group.

Figure 3: SThree quarterly net fee income since Q1 2016.



Source: FactSet, Radnor

Estimate revisions and relative valuation

Post the Q2 trading update (see link to previous note here), we upgraded our FY22 net fees and PBT estimate by **6%** and **8%** respectively to **£412.3m** and **£71.5m**.

Post Q2 upgrades we are keeping our net fee and PBT estimates unchanged …

At this stage we **remain comfortable** with our headline net fee, margin and PBT estimates for FY22 and beyond. There is undoubtedly a tricky balancing act between the strength of current trading; a natural caution relating to the macro backdrop and the H2 impact of the internal investment spend.

Tax driven drive tweak upwards to EPS / DPS …

We are tweaking upwards our EPS (+6% in FY22) and dividend expectations (+15% to 15.0p in FY22) to reflect the lower than expected effective tax rate in H1 (lower US tax expectations) flowing through to the fully year and commentary around the lower end of the 2.5x to 3.0x dividend cover range.

If Q3 net fee growth is in line with Q2 run rate then further upgrades are likely …

As we flagged at the time of the Q2 trading update; our upgraded estimates assume 9% net fee growth in H2 vs H2 FY21. This 9% growth expectation does sit someway below the H1 net fee growth run rate. Our focus will be on the Q3 outcome, which is currently scheduled for 19th September. If net fee growth is maintained at anywhere near the current trajectory then we will, almost certainly, be looking at further upgrades.

We do expect market consensus to move ahead as the range tightens …

Although we are not upgrading our net fee and PBT estimates today, we do expect to see overall market consensus for SThree to move ahead. Our £71.5m PBT estimate for FY22 sat towards the upper end of the range of forecasts, with a number of brokers looking for PBT in the low £60m range. We expect these estimates to move ahead with the range coalescing around the high £60m- £72m range.

H1 margins are not sustainable in the short term …

As expected, H1 EBIT margins came in at an impressive 22%. The company has been at pains to make the point that this level of margin is not sustainable over the short term as the business runs "hot" in terms of client demand and while the cost of headcount re-investment has yet to fully wash through. The well flagged internal investment programme, predominantly comprising significant CRM, ERP and HR new system implementations, is also a major moving part to consider for H2.

Guidance throughout the year has been for this cost to be H2 weighted and to be in the range of 1-2% of net fees. We have always assumed c.£8m of H2 P&L impact and this has been reaffirmed by the company. A similar level of cost impact is anticipated for FY23, although this will be more evenly spread between H1 / H2. **It is important to note that the £8m of cost impact this year is not a "new" number and is already baked into consensus.**

Pre investment margins are still expected to show a strong improvement in FY22 …

Based on our current estimates, we are looking for the full year FY22 EBIT margin to come in at 17.5%, an improvement of 0.4% vs FY21. This implies an H2 EBIT margin of 13.2% as the initial cost impact of the investment programme kicks in. This is an unusual shape for SThree, where profitability has traditionally been H2 weighted (Q4 is the group's strongest net fee quarter). If we adjust back for the £8m of investment spend currently guided by the company, then this implies a pre-spend H2 FY22 EBIT of £35.5m (an underlying H2 margin of 17.5%) and full year underlying EBIT / margin of £80.2m / 19.4%.

Encouraging to see SThree capable of generating a margin consistent with longer term ambitions …

The company reaffirmed its ambition to deliver a medium to longer term sustainable EBIT margin of greater than 21% by 2024, and they are clearly making good progress against that ambition.

Net, net FY22 will appear, superficially, as an unusual year for SThree. H1 margins will not be a guide to the full year outcome and there is every likelihood that the group could see the majority of its profits earned in H1, which would be a reversal of the more traditional seasonal pattern. However, as the investment costs become more evenly spread through FY23, we would expect the more normal H2 profit bias to reassert itself.

In Figure 4 & 5 below, we show the evolution of the two-year prospective PE multiple for both SThree and the UK staffing Peer group in the UK (Hays, Page, Robert Walters). We also show the evolution of the SThree PE discount / premium to the same peer group.

Figure 4: 2 Year prospective PE multiple

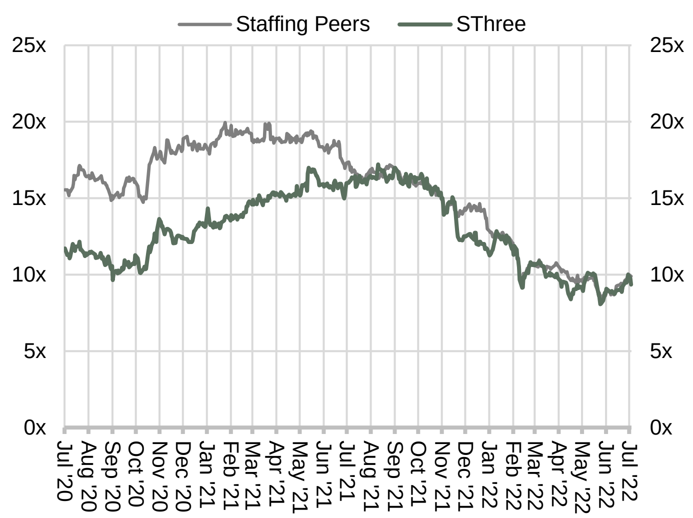
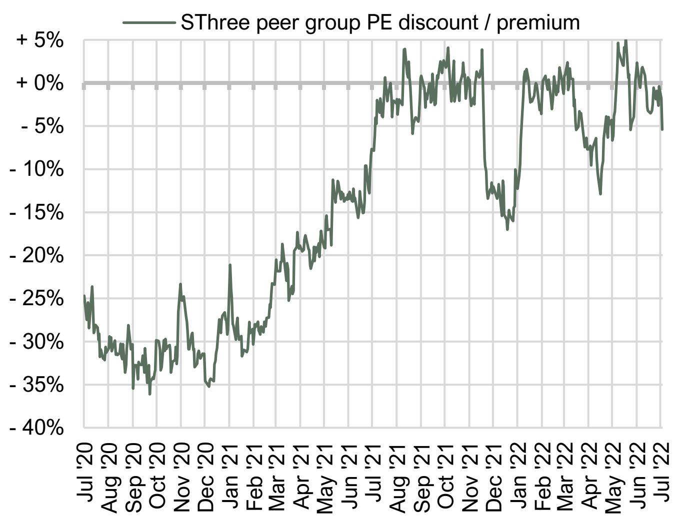


Figure 5: SThree PE discount / premium



Source: FactSet, Radnor

We can see from the above that SThree's forward valuation has been moving in line with the UK Staffing peer group average through much of the second half of 2021 to date. We find this correlation somewhat puzzling give the extent of SThree's outperformance through recent downturns. If the market is indeed pricing in a major cyclical negative shock, then there is a strong argument for SThree trading at a sustained premium to the perm heavy peer group.

With the shares now standing on a FY22 / FY23 PE of 9.7x / 8.9x respectively and a dividend yield of 4.1% / 4.5% we can see an attractive combination of solid top line growth and underlying margin progression at a very attractive entry multiple underpinned by a solid yield.

SThree PLC

STEM

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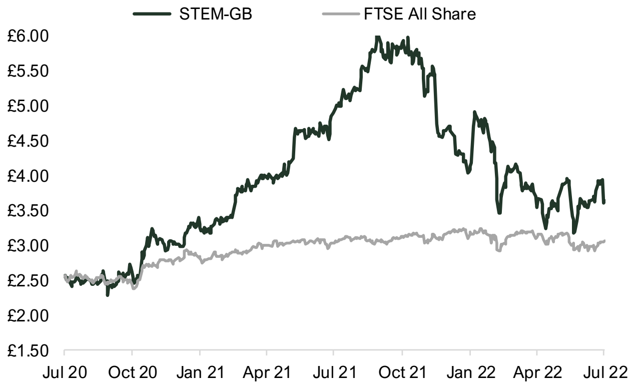
Price (p):	**364 1/2 p**
Market Cap:	484 m
EV:	434 m

PROFIT & LOSS

Year to 31 November, £m	2020	2021	2022E	2023E	2024E
Group Sales	**1,202.6**	**1,330.7**	**1,649.3**	**1,768.2**	**1,895.9**
EMEA (ex DACH)	*117.6*	*127.2*	*145.0*	*153.7*	*162.9*
DACH	*105.8*	*129.4*	*152.7*	*164.9*	*178.1*
USA	*77.2*	*89.3*	*102.9*	*111.1*	*120.0*
APAC	*7.9*	*9.8*	*11.8*	*12.3*	*13.0*
Group Net Fees	**308.6**	**355.7**	**412.3**	**442.1**	**474.0**
Op. Exp.	(257.8)	(276.6)	(320.6)	(342.9)	(365.2)
EBITDA	**50.7**	**79.1**	**91.8**	**99.2**	**108.7**
Depr & Amort	(6.4)	(6.3)	(6.6)	(6.6)	(6.6)
Lease Depreciation	(13.0)	(12.0)	(13.0)	(13.0)	(13.0)
EBITA - Adjusted	**31.3**	**60.8**	**72.2**	**79.6**	**89.1**
Associates & JV's	-	-	-	-	-
Net Bank Interest	(1.2)	(0.8)	(0.7)	(0.7)	(0.6)
PBT - Adjusted	**30.1**	**60.0**	**71.5**	**78.9**	**88.5**
Non Operating Items	(1.3)	-	-	-	-
Other Financial Items	-	-	-	-	-
PBT - IFRS	**28.8**	**60.0**	**71.5**	**78.9**	**88.5**
Tax - Adjusted	(11.7)	(17.9)	(20.0)	(22.9)	(26.6)
Tax rate - Adjusted	*39.0%*	*29.8%*	*28.0%*	*29.0%*	*30.0%*
Minority interests	-	-	-	-	-
No. shares m, diluted	136.4	136.7	137.0	137.5	138.0
Adj EPS (p), diluted	**13.5**	**30.8**	**37.6**	**40.7**	**44.9**
Total DPS (p)	5.0	11.0	15.0	16.3	17.3

PRICE CHART - 2 YEAR ABSOLUTE vs FTSE ALL SHARE



Source: FactSet

SHAREHOLDERS

	% of ord. Share capital
Kempen Cap Mgmt	9.5%
JO Hambro Cap Mgmt	6.2%
Littlejohn & Co	5.4%
BlackRock	5.2%
Allianz Global	4.9%
JPMorgan AM	4.4%
Polar Capital	4.0%
	39.6%

CASH FLOW

Year to 31 November, £m	2020	2021	2022E	2023E	2024E
EBITDA	50.7	79.1	91.8	99.2	108.7
Working Capital	25.3	(26.6)	(38.2)	(22.5)	(30.7)
Provisions / Exceptionals	0.8	2.0	(0.8)	(0.8)	(0.8)
Gross Op Cashflow	**76.9**	**54.5**	**52.7**	**75.9**	**77.2**
Cash Tax	(10.5)	(16.8)	(17.9)	(20.0)	(22.9)
Cash Intererest	0.1	(0.9)	(0.7)	(0.7)	(0.6)
Net Op Cashflow	**66.5**	**36.9**	**34.1**	**55.2**	**53.8**
Capex	(5.3)	(2.6)	(6.0)	(6.0)	(6.0)
Free Cashflow	**61.2**	**34.2**	**28.1**	**49.2**	**47.8**
Dividends	(6.7)	(6.7)	(15.0)	(20.6)	(22.4)
Acquisitions & Inv.	-	-	-	-	-
Other Non Operating	(13.3)	(12.5)	(12.5)	(12.5)	(12.5)
Net Cashflow	**41.3**	**15.1**	**0.6**	**16.2**	**12.9**
Net Cash (Debt)	**49.9**	**57.5**	**56.1**	**70.2**	**81.1**

Announcements

Date	Event
20 June 2022	Q2 update
21 March 2022	Q1 update
31 January 2021	FY21 results
13 December 2021	Q4 update
13 September 2021	Q3 update
19 July 2021	H1 FY21 results

RATIOS

	2020	2021	2022E	2023E	2024E
RoE	14.3%	26.6%	26.3%	24.1%	22.5%
RoCE	39.8%	60.4%	51.7%	49.0%	46.0%
Asset Turnover (x)	0.2x	0.1x	0.1x	0.1x	0.1x
NWC % Revenue	4.8%	6.0%	7.1%	7.9%	9.0%
Op Cash % EBITA	245.7%	89.6%	73.0%	95.4%	86.6%
Net Debt / EBITDA	1.0x	0.7x	0.6x	0.7x	0.7x

BALANCE SHEET

Year to 31 November, £m	2020	2021e	2022E	2023E	2024E
Intangibles	4.4	2.5	2.5	2.5	2.5
P,P+E	40.8	38.1	38.7	39.3	39.9
Tax Asset & Other	1.5	4.5	4.5	4.5	4.5
Total Fixed Assets	**46.7**	**45.0**	**45.6**	**46.2**	**46.8**
Current Assets	237.4	298.0	371.1	397.9	426.6
Current Liabilities	(179.5)	(218.4)	(253.2)	(257.5)	(255.5)
Net Current Assets	**57.9**	**79.6**	**117.9**	**140.4**	**171.1**
Long Term Liabilities	(26.0)	(24.0)	(24.0)	(24.0)	(24.0)
Net Cash (Debt)	49.9	57.5	56.1	70.2	81.1
Net Assets	**128.5**	**158.1**	**195.6**	**232.8**	**275.0**

VALUATION

Fiscal	2020	2021	2022E	2023E	2024E
P/E	27.0x	11.8x	9.7x	8.9x	8.1x
EV/EBITDA	8.6x	5.5x	4.7x	4.4x	4.0x
Div Yield	1.4%	3.0%	4.1%	4.5%	4.7%
FCF Yield	14.1%	7.9%	6.5%	11.3%	11.0%
Net Fees growth	-8.7%	15.3%	15.9%	7.2%	7.2%
EPS growth	-58.3%	128.6%	21.9%	8.5%	10.2%
DPS growth	-2.0%	120.0%	36.6%	8.5%	6.0%

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