RADNOR
CAPITAL PARTNERS

SThree PLC

STHR | Small Cap | Support Services |277p |£357m

Q4 update – Not all doom and gloom

In amongst the gloom, the SThree Q4 trading update was a reassuring piece of good news with the company flagging a strong end to FY18 and an outcome above the top end of expectations. The departure of the CEO, Gary Elden, was a surprise but on the flip side; new leadership will create new opportunities for a group with considerable global reach, scale and management depth.

*So where is the valuation now, following a poor month for cyclical equities in general? On our revised estimates, SThree now trades on a FY18 PE of **9.5x**, falling to **8.6x** for FY19E. The dividend yield is **5.1%**, covered more than 2.0x. Based on market consensus, SThree trades at a 24% PE discount to the immediate peer group. Given the positive trading commentary and the strong start to FY19E, any potential bad news looks more than baked into the share price.*

1 Year Chart

- **Full year trading update:** Last week's update confirmed a strong Q4 with the full year result now expected to be above the top end of market expectations. **As a result, we are upgrading our FY18 PBT/EPS estimate by c.4%.** We are also pencilling some minor upgrades for FY19 (the Q4 exit run rate underpins a good proportion of H1 FY19), although remain mindful of the potential macro challenges.

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

- **Trading highlights:** Overall gross profit ("GP") growth of 12% YoY in Q4 and FY18 as a whole is a very reassuring outcome. By sector, Energy and Engineering were standout performers. By region, Continental Europe (+20% YoY) and Asia Pacific (+11% YoY) are the best performing by GP growth. Contract growth was 14% YoY, underlining the relevance of Contract recruiting within STEM markets.

- **Balance sheet:** The group has flagged a year end net debt position of c.£4m, which is materially better than our original expectations (-£14m). Given the one-time cash costs of the Glasgow back office relocation and the continued growth of the Contract book (cash consumptive), this is a strong result reflecting tighter working capital management through the year.

- **Valuation:** In our recent initiation of coverage note (link here), we highlighted the valuation disconnect between SThree and the immediate peers. Given the positive trading momentum; strong exit rate into FY19; low UK exposure and the clear focus on STEM growth markets, we continue to believe the extent of the discount feels anomalous.

20th December 2018

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YE – November	NFI, £m	PBT adj, £m	EPS (p)	Div (p)	Net Cash, £m	PER x	Yield %
FY 2016A	258.7	37.7	21.1	14.0	10.0	13.1	5.1
FY 2017A	287.7	44.5	24.7	14.0	5.6	11.2	5.1
FY 2018E	*319.0*	*52.0*	*29.1*	*14.1*	*-4.0*	*9.5*	*5.1*
FY 2019E	*349.0*	*57.8*	*32.2*	*14.5*	*3.3*	*8.6*	*5.2*
FY 2020E	*370.0*	*62.0*	*34.3*	*15.0*	*16.2*	*8.1*	*5.4*

Source: Radnor Capital Partners

Full Year Trading Update

The key highlights of the trading update were:

- Overall group gross profit up 12% for both Q4 and the full year (the market had been expecting 10% YoY);
- Key positive regional contributors for FY18 were Continental Europe +20%; North America +8%; and Asia Pacific +11%. Within Europe, DACH continued to be the standout performer with YoY gross profit growth +21%.
- UK & Ireland saw gross profit decline by 5% over the year, although this was primarily driven by the planned restructuring / headcount reductions in the Permanent business. Underlying UK productivity increased by 5% over the year.
- The overall business mix continues to evolve away from UK & Ireland (17% of gross profit in FY18, down from 20% in FY17) and Permanent (28% of gross profit in FY18, down from 29% in FY17);
- Contract momentum has remained strong throughout the year; with Q4 Contract YoY growth of 15% and 14% for FY18; with the group confirming a strong exit growth rate heading into Q1 FY19E. Contract has grown consistently above 10% for each quarter.
- The Permanent business is still growing, but at a slower rate than Contract. This differential is driven by two factors; firstly, Permanent is the less relevant staffing model in many of the key STEM markets that SThree have prioritised, and secondly, group growth investment has focused on Contract in recent times, while some of the Permanent businesses (UK primarily) have been restructured to focus on yield and margin rather than top line growth.
- Overall, Permanent gross profit growth was in line with expectations at 6% for both the year and Q4.
- There are no major variations below the gross profit line so this outperformance should drop through to PBT and EPS. The full year PBT outcome is expected to be “slightly” above the top end of market expectations range, which implies a result in excess of £51.4m. **We have upgraded our FY18E PBT / EPS estimate by c.4% to £52.0m / 29.1p respectively.**
- Elsewhere, the group highlighted a materially better than expected balance sheet outcome, with FY18 net debt now expected to be c.£4m (market expectations had been for c.£10m of net debt and we had originally modelled £15.1m). The key drivers here have been a better than expected working capital performance post the Glasgow back office relocation with a reduction in days sales outstanding in the final quarter. FY18 had been flagged as a year of cash investment, not least through the Glasgow move (exceptional cash cost of £14m) and the continued growth in the Contract business (cash consumptive at the outset). However, we estimate the group would have reported net cash of c.£10m for the year in the absence of the Glasgow move.

We believe the combination of the strong Q4 exit growth rate and the better than expected balance sheet outcome should settle investor nerves. The longer duration nature of the Contract book means that this exit rate underpins a good portion of H1 FY19 visibility. The balance sheet result will also mean that all eyes will remain on the full year dividend announcement as EPS cover builds beyond the 2.0x target level. Unless there is a marked deterioration between now and the end of Jan, we believe the risks to our 14.1p full year dividend estimate lie on the upside.

CEO succession

What was unexpected was the news, that after six years as CEO and twenty-eight years with the group, Gary Elden has announced his departure. The succession plan is underway and the process is expected to be finalised by the AGM in April.

We believe any incoming CEO will inherit a business in good shape. Performance over the last few years has been strong and the group has been able to establish a number of leading positions in its target, specialist markets. The group has global scale and reach and clearly has built a significant depth of management below the C suite. The stage is set, so to speak.

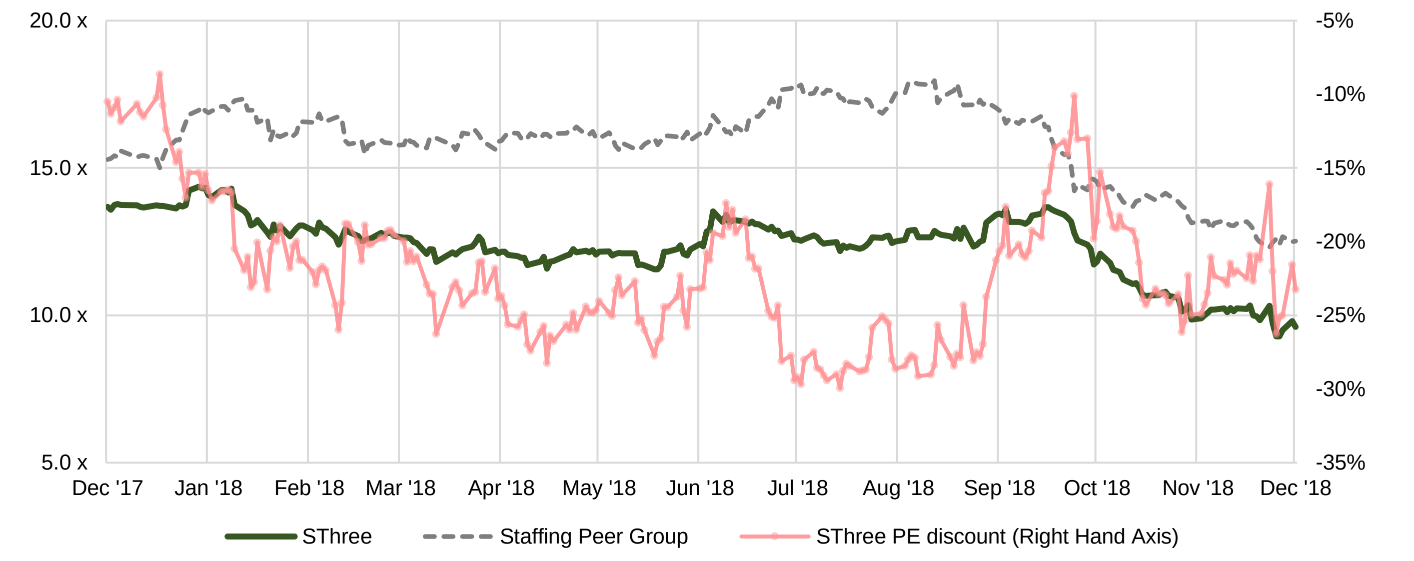
We are nervous about speculating as to motives behind the departure although we do note Gary's length of tenure at SThree and a clear sense of a job well done. Gary has highlighted that he intends to retain his equity stake in the business, in a similar fashion to other SThree founders, which speaks volumes as to the nature of the change.

We believe investors will probably have mixed feelings regarding this news; which coupled with other potential macro risks, may temper any re-rating exuberance. However, our sense is that this is an organic moment rather than one forced by corporate stress.

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

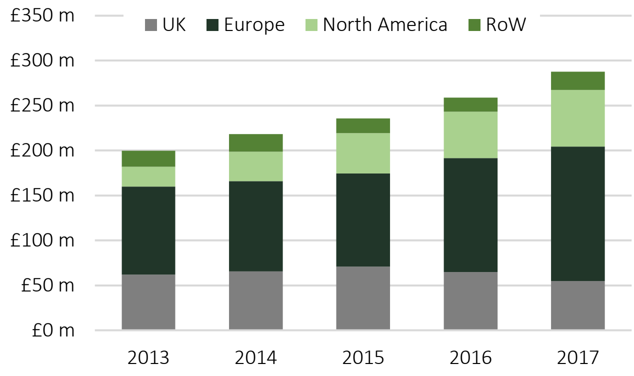
We can see the effect of recent volatility, with the SThree discount narrowing considerably through most of November before widening out as macro newsflow worsened. We sense a sensible degree of recovery but would still question the extent of the discount given positive trading performance and a healthy outlook heading into 2019.

Key Points – Investment Case

Market Blues	Professional Staffing stocks in the UK have recently come under downside pressure as the market has moved to discount a weaker international and domestic outlook. SThree has been caught up in this general swing, posting a recent low of 260p, down from a 52-week high of 385p. SThree has been keeping good company with the other Professional Staffers suffering similar peak to trough swings, despite the clear resilience of the SThree model.
Positive Trading	The Q4 trading update confirmed the positive momentum referenced in previous updates and flagged a better than expected outcome for the current financial year. SThree has seen consistent **upgrades** from the house brokers (UBS & Liberum) throughout the course of the current financial year.
Non-UK Exposure	**83%** of FY18 gross profit was 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 gross profit) relative to Permanent (28% of FY18 gross profit). 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.
Valuation	Over the last two years, SThree has traded within a 10% - 30% PE discount range to the immediate peer group. This range had narrowed through much of Q2 and Q3 2018 although 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 9.5x and yield of 5.1% does not fully recognise SThree's growth and risk characteristics.

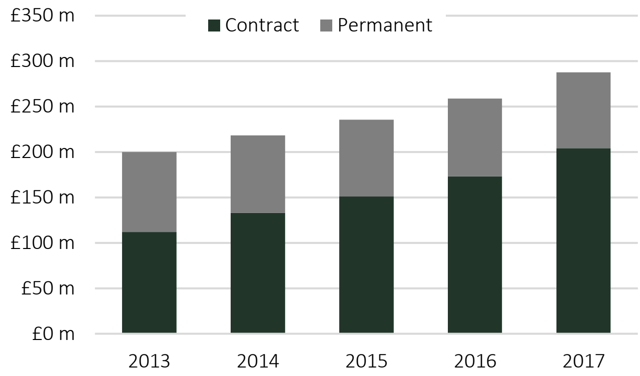
SThree - Key charts

Geographic Gross Profit 5 year track record



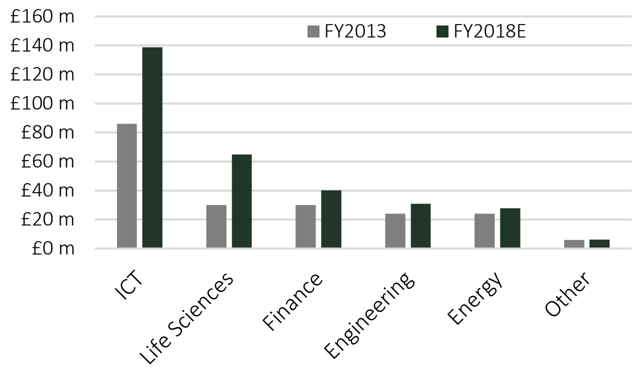
Source: FactSet, Radnor

Contract / Perm gross profit 5 year track record



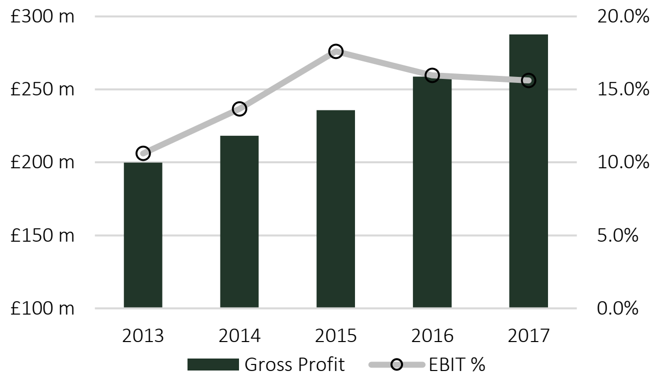
Source: FactSet, Radnor

STEM market gross profit 2013 vs 2018



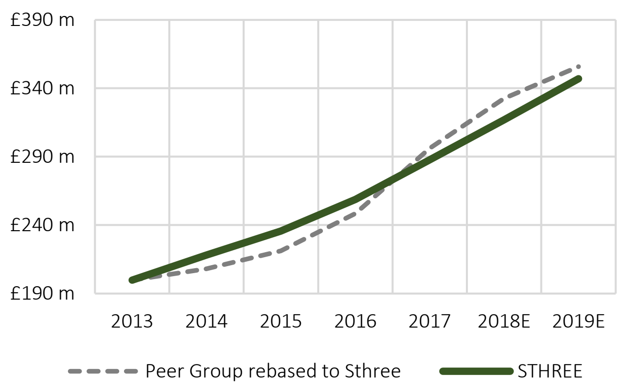
Source: FactSet, Radnor

Gross Profit and EBIT margins 5 year track record



Source: FactSet, Radnor

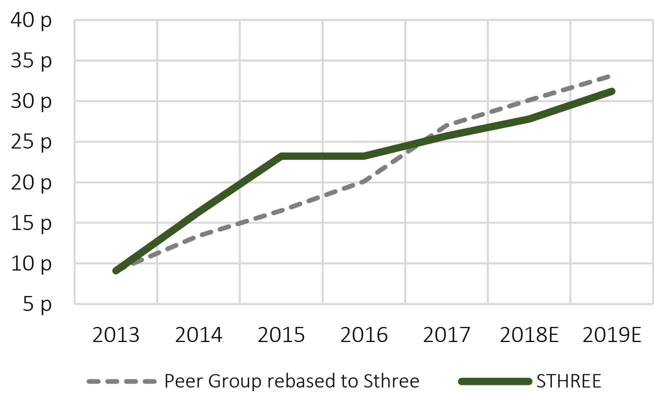
Gross Profit – SThree vs Peers



Peers = Hays, PageGroup, Robert Walters

Source: FactSet, Radnor

EPS – SThree vs Peers



Peers = Hays, PageGroup, Robert Walters

Source: FactSet, Radnor

Key Estimates

SThree PLC

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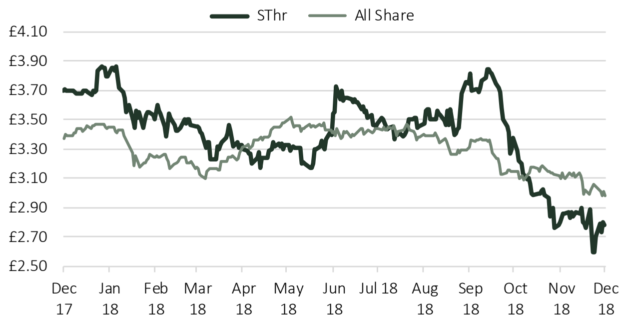
Price (p): **277 p**
Market Cap: 357 m
EV: 361 m

PROFIT & LOSS						
Year to 31 November, £m	**2015**	**2016**	**2017**	**2018E**	**2019E**	**2020E**
Group Sales	**848.8**	**959.9**	**1,114.5**	**1,250.0**	**1,365.0**	**1,425.0**
Europe	*103.7*	*126.8*	*149.6*	*175.0*	*197.0*	*213.0*
UK	*70.7*	*64.7*	*54.7*	*55.0*	*56.0*	*55.0*
North America	*44.8*	*51.7*	*63.3*	*69.0*	*75.0*	*80.0*
Asia Pacific	*16.5*	*15.5*	*20.1*	*20.0*	*21.0*	*22.0*
Group NFI	**235.7**	**258.7**	**287.7**	**319.0**	**349.0**	**370.0**
Op. Exp.	(192.2)	(214.8)	(237.0)	(260.7)	(285.0)	(302.0)
EBITDA	**43.5**	**43.9**	**50.7**	**58.3**	**64.0**	**68.0**
Depr & Amort	(5.1)	(5.7)	(5.8)	(5.9)	(6.0)	(5.9)
EBITA - Adjusted	**38.4**	**38.2**	**44.9**	**52.4**	**58.0**	**62.1**
Associates & JV's	-	-	(0.1)	-	-	-
Net Bank Interest	(0.7)	(0.5)	(0.3)	(0.4)	(0.2)	(0.1)
PBT - Adjusted	**37.7**	**37.7**	**44.5**	**52.0**	**57.8**	**62.0**
Non Operating Items	-	-	(6.7)	(8.3)	-	-
Other Financial Items	-	-	-	-	-	-
PBT - IFRS	**37.7**	**37.7**	**37.8**	**43.7**	**57.8**	**62.0**
Tax	(11.4)	(10.1)	(10.1)	(12.7)	(14.3)	(15.7)
Tax - Adjusted	(11.3)	(9.9)	(11.7)	(12.7)	(14.3)	(15.7)
Tax rate - Adjusted	*30.0%*	*26.3%*	*26.3%*	*24.4%*	*24.7%*	*25.3%*
Minority interests	-	-	-	-	-	-
No. shares m, diluted	133.0	132.0	133.0	135.0	135.0	135.0
IFRS EPS (p)	-	-	-	-	-	-
Adj EPS (p), diluted	**19.8**	**21.1**	**24.7**	**29.1**	**32.2**	**34.3**
Total DPS (p)	14.0	14.0	14.0	14.1	14.5	15.0

PRICE CHART - 1 YEAR ABSOLUTE vs FTSE ALL SHARE



Source: FactSet

SHAREHOLDERS	
	% of ord. Share capital
JO Hambro Cap Mgmt	11.1%
Franklin Templeton	9.3%
SThree Founders	7.7%
Harris Assoc	5.1%
JPMorgan Asset Mgmt	4.3%
Allianz Global	4.2%
M&G	4.2%
UBS Asset Mgmt	3.5%
	49.4%

CASH FLOW						
Year to 31 November, £m	**2015**	**2016**	**2017e**	**2018E**	**2019E**	**2020E**
EBITDA	43.5	43.9	50.7	58.3	64.0	68.0
Working Capital	8.1	(4.3)	(7.7)	(12.6)	(11.8)	(8.3)
Provisions / Exceptionals	5.6	2.6	(2.9)	(14.0)	(3.0)	(3.0)
Gross Op Cashflow	**57.2**	**42.2**	**40.1**	**31.7**	**49.2**	**56.7**
Cash Tax	(10.8)	(8.5)	(10.9)	(14.0)	(12.7)	(14.3)
Cash Intererest	(0.7)	(0.5)	(0.3)	(0.4)	(0.4)	(0.4)
Net Op Cashflow	**45.7**	**33.2**	**28.9**	**17.3**	**36.1**	**42.0**
Capex	(8.6)	(6.1)	(5.8)	(5.3)	(4.8)	(4.5)
Free Cashflow	**37.1**	**27.1**	**23.1**	**12.0**	**31.3**	**37.5**
Dividends	(17.7)	(18.0)	(18.0)	(18.6)	(19.0)	(19.6)
Acquisitions & Inv.	2.0	(0.7)	(1.2)	-	-	-
Other Non Operating	(5.4)	(4.6)	(8.3)	(3.0)	(5.0)	(5.0)
Net Cashflow	**16.0**	**3.8**	**(4.4)**	**(9.6)**	**7.3**	**12.9**
Net Cash (Debt)	**6.2**	**10.0**	**5.6**	**(4.0)**	**3.3**	**16.2**

Announcements	
Date	**Event**
December 2018	Q4 trading update
September 2018	Q3 trading update
July 2018	H1 results FY 2018
June 2018	H1 trading update
March 2018	Q1 trading update
January 2018	Final results FY 2017

RATIOS					
	2016	**2017**	**2018E**	**2019E**	**2020E**
RoE	36.7%	40.6%	40.8%	38.1%	34.1%
RoCE	71.8%	68.2%	69.8%	57.8%	56.0%
Asset Turnover (x)	0.1x	0.1x	0.1x	0.1x	0.1x
NWC % Revenue	17.3%	18.5%	24.4%	25.0%	25.5%
Op Cash % EBITA	110.5%	89.3%	60.5%	84.8%	91.3%
Net Debt / EBITDA	0.1x	0.2x	0.1x	-0.1x	0.1x

BALANCE SHEET						
Year to 31 November, £m	**2015**	**2016**	**2017e**	**2018E**	**2019E**	**2020E**
Intangibles	11.1	11.6	11.4	11.4	11.4	11.4
P,P+E	5.6	7.1	6.7	7.3	8.4	9.8
Tax Asset & Other	1.8	3.2	6.0	6.0	6.0	6.0
Total Fixed Assets	**18.5**	**21.9**	**24.1**	**24.7**	**25.8**	**27.2**
Current Assets	186.4	209.6	249.4	277.4	311.2	340.4
Current Liabilities	(144.4)	(154.9)	(190.7)	(203.6)	(220.7)	(229.7)
Net Current Assets	**42.0**	**54.7**	**58.7**	**73.8**	**90.5**	**110.7**
Long Term Liabilities	(1.1)	(0.9)	(2.1)	(2.1)	(2.1)	(2.1)
Net Assets	**59.4**	**75.7**	**80.7**	**96.4**	**114.2**	**135.8**

VALUATION					
Fiscal	**2016**	**2017**	**2018E**	**2019E**	**2020E**
P/E	13.1x	11.2x	9.5x	8.6x	8.1x
EV/EBITDA	8.7x	7.4x	6.4x	6.2x	5.8x
Div Yield	5.1%	5.1%	5.1%	5.2%	5.4%
FCF Yield	7.5%	6.4%	3.3%	8.7%	10.4%
NFI growth	9.8%	11.2%	10.9%	9.4%	6.0%
EPS growth	6.6%	17.1%	17.8%	10.7%	6.5%
DPS growth	0.0%	0.0%	0.7%	2.8%	3.4%

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