SThree PLC

STHR | Small Cap | Support Services |306p |£400m

Business model resilience against an uncertain outlook

The final results did not contain any surprises but did provide more colour around the trading outlook. The strong exit momentum was confirmed; especially in key overseas markets, which helps to underpin H1 visibility. However, despite positive momentum heading into 2019, SThree is having to contest with poor macro data coming out of the Eurozone, and Germany in particular. Past experience suggests SThree's unique combination of STEM and Contract focus should hold it in relative good stead.

*SThree has been subject to a Bull/Bear tug of war since the start of Q4 2018. Although SThree is still some way off its recent highs, it is now also some way off its lows, suggesting the more extreme cyclical concerns have now been priced in. The return of SThree to dividend growth is also a positive catalyst. SThree continues to trade at a material discount to the Staffing peer group (FY19E PE of **9.4x**, 5% yield) despite strong operational performance and late cycle attractions.*

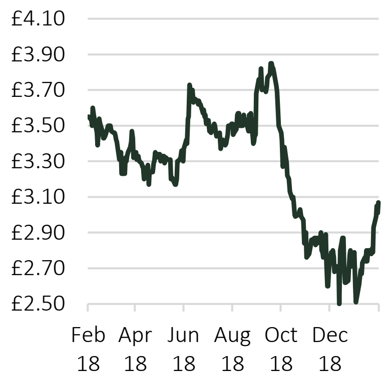
- **Final results:** FY2018 came in slightly ahead of our already upgraded expectations at the gross profit, EPS and net debt lines, reflecting what was clearly a very strong performance across the year. The better than expected cashflow result was especially notable given the extent of the Glasgow relocation exercise.

- **Relative attractions:** SThree is closely tracking its more Perm heavy listed peers in terms of prospective gross profit and earnings momentum. The Perm heavy model is far more exposed to any initial cyclical shock, which is not currently factored into relative valuations.

- **All eyes on CEO succession:** With Gary Elden's departure approaching, investors are clearly looking for news on who will take over the reins and what this implies for strategic direction and momentum. On the former, we believe any impacts will be medium, rather than short term in nature. SThree's positioning and focus is clear and the strength of results suggests that nothing major is broken and does not need fixing. The latter is more interesting with SThree already actively investing in innovative technology led recruitment business models.

- **Valuation:** The SThree PE discount to the peer group has now narrowed back to c.25%, having blown out to 35% at the trough. Given SThree's STEM and Contract focus, there is an argument that the discount should not exist at all at this late point in the cycle. With SThree's return to dividend growth there should also be attractions for investors looking for a combination of growth and income.

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

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YE – November	NFI, £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	12.3	4.6
FY 2018A	321.1	53.3	29.6	14.5	-4.1	10.3	4.7
FY 2019E	*344.1*	*58.5*	*32.6*	*15.0*	*7.1*	*9.4*	*4.9*
FY 2020E	*362.1*	*63.2*	*35.0*	*15.5*	*18.0*	*8.7*	*5.1*
FY 2020E	*379.0*	*67.2*	*36.9*	*16.0*	*40.7*	*8.3*	*5.2*

Source: Radnor Capital Partners

Full Year Results

SThree delivered FY 18 results (Nov Yr end), materially ahead of our (and wider market) original expectations. SThree had last formally updated the market on Dec 14, in their Q4 trading update, which drove some material upgrades to market consensus estimates.

Gross profit came in at **£321.1m**, vs our £319.0m forecast (market consensus was for £310.0m prior to the Q4 update, although the "house" consensus was lower at £304m)

- Adjusted pretax profit (PBT) came in at **£53.4m**, vs our £52.0m forecast (market consensus was for £50.3m prior to the Q4 update)
- Net debt came in at **£4.1m,** a material outperformance vs our £14m forecast (market consensus was for £0.6m, with a "house" consensus of £6.0m)
- Fully diluted, adjusted EPS came in at **29.7p**, vs our 29.1p forecast (market consensus was for 27.4p, with a "house" consensus of 28.4p
- Dividend, 14,5p for FY 18, up 4% YoY. This compares with our 14.1p forecast.

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.

<u>Gross Profit</u>

In more detail, Group gross profit ('GP') was up 12% YoY, at £321.1m. In terms of key ('STEM') employment sectors, ICT delivered growth of 12%, Life Sciences 8%, Engineering 16% and Global Energy 30%. By region, the GP growth was largely delivered through Continental Europe and the USA; the former driven by Germany and the Netherlands which together saw growth of 20%, whilst the USA was up 8%.

SThree has further strengthened its market position in Continental Europe in FY18, which now accounts for c57% of group GP. In line with expectations however, UK & Ireland GP declined 5% YoY. As a result of this, UK&I now accounts for c17% of group GP. Management focus in UK&I remains on improving consultant productivity and margins rather than building growth through headcount expansion.

Importantly, given the group focus, Contract GP was up 14% YoY, vs Permanent, 6% YoY. At the year end, Contract headcount was up 8% YoY, and all regions bar UK&I reported increased headcount and GP growth in Contract. The increased weighting towards Contract has created a more resilient business in times of uncertainty, providing stronger and more sustainable 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 H1 FY19 visibility.

As an aside, currency had negligible impact on FY 18 reported results, with only modest changes YoY in average EUR/GBP and USD/GBP rates. Revenue for the year, for example, was up 13% on both constant currency and reported basis to £1,258.2 million.

<u>Operating Profit</u>

SThree FY 18 adjusted op profit, £53.9m. The 1.2% increase YoY in the group EBIT conversion ratio (16.8% vs 15.6%) was driven by three factors:

- Productivity per consultant (Contract +1%, Perm +7%)

- Number of heads (Contract +13%, Perm -1%)

- Cost savings from Glasgow. Cost savings from the Glasgow relocation exercise are running ahead of expectations (contributing £2.5m in FY18). The relocation is on track to deliver £5.5m per annum, c.£1m ahead of original expectations,

Adjusted operating costs increased by 10% to £267.2 million, driven by additional investment in headcount (8% increase year on year), 10% increase in personnel costs (e.g salaries; commissions and bonuses in line with improved GP), and £0.9 million increase in property costs.

Our adjusted PBT excludes restructuring costs of £6.4 m incurred during the year on the relocation of the group support function to Glasgow. SThree also continues to invest in in-house innovation initiatives (R&D), expensing a total of £2.4m in FY2018 (up slightly YoY).

Balance Sheet & Net Debt

The FY2018 SThree net debt position of £4.1m, is a strong result in our view, being materially better than our original expectations prior to Dec 14, which were pitched at c£14m.

SThree started the year with the net cash of £5.6 million. Reported cash conversion in FY2018, 67%, was down slightly on FY2017 but requires further explanation. In terms of the YoY bridge, the two largest negative cashflow items were the Glasgow relocation (-£11.5m) and working capital (-£25.3m). Adjusting for these two items would have seen SThree report net cash of c.£19m, rather than the reported £4.1m of net debt.

- The Glasgow back office relocation involved over 200 employees and will be non recurring in 2020. There are still some further local government grant receivables in play but these are not expected to exceed £2m.

- The working capital movement is driven by two primary factors. Firstly, the continuing growth of the Contract book is cash consumptive. We estimate this accounted for c.40% of the working capital movement and is a function of normal business growth. Secondly, the Glasgow move did cause some short term delay to the usual working capital cycle. This is expected to normalise during the course of FY2019. Overall, DSO (days sales outstanding), were higher at 44.7 (+4 YoY), with a reversion back to the low 40s baked into our estimates.

With net assets of £101.7m, at FY2018 period end, and net debt of £4m, SThree is practically ungeared. This in turn is reflected on the P&L, where interest expense is only £0.5m. For investors this should be reassuring. In our view, SThree’s strong balance sheet might well also prove a source of comfort to clients, in increasingly uncertain times as well as underpinning a key competive strength of SThree in the Contract market.

Dividend

To recap, the SThree FY dividend is 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 have assumed a gentle rate of dividend increase moving forward, which would place the payout at 2.2x to 2.3x cover.

Revenue recognition & Cash-flow

On 11th January 2019, Staffline PLC (STAF.L) delayed the publication of their final results, citing concerns over invoicing and payroll practices within their Recruitment division which, if proven, could have a material impact on reported profitability. Staffline shares were suspended although not before a 33% hit to the share price. The market awaits a further update.

Staffline is a very different business to a more traditional recruiter like SThree. We do not believe there is any relevant read-across to SThree and believe the issues likely to be facing Staffline will be largely self-inflicted and specific to their business model. However, it is worth briefly highlighting the key points of the SThree revenue recognition policy.

- Contract revenue is recognised when the service has been provided by the Contractor to the client, which is determined by timesheet submission. Revenue earned but not yet invoiced sits within Accrued Income in the balance sheet, which is tested on a regular basis and subject to Audit Committee scrutiny. Accrued income combines with the natural invoice cycle to drive the change in receivables line in the cashflow statement. It is this dynamic that drives cash consumption from a growing Contract book.
- Even where SThree places multiple contractors with a single client; the revenue / invoicing / settlement cycle is still fundamentally driven by individual timesheets. SThree does not employ multi-year; framework agreements where individual contractor payments are disconnected from the recognised overall framework value.
- Revenue recognition within Permanent is even simpler. Here revenue (normally a fixed percentage of the candidate's remuneration package) is recognised upon the candidate's role commencing, at which point the invoice is raised and submitted to the client.
- The initial IFRS 15 impact study (conducted in 2018) determined that recognition of Contract Accrual income that is deemed to be "not highly probable" should be deferred. The new policy will result in a reduction to opening reserves of c.£2m-£3m on the date of the standard adoption.

In Figure 1 below, we show the last 5 years working capital / provision movements through the cashflow statement as a percentage of gross revenue (ie, capturing the full value of contractor payments passing through SThree).

Figure 1: SThree – Working capital movements vs Gross Revenue

	FY2014	FY2015	FY2016	FY2017	FY2018
Gross Revenue, £m	**746.9**	**848.8**	**959.9**	**1,114.5**	**1,258.2**
Change in Gross Revenue, £m	112.6	101.9	111.1	154.6	143.7
Change in Receivables, £m	(44.6)	3.6	(9.4)	(35.7)	(55.4)
Change in Payables, £m	27.7	9.4	5.7	19.3	30.1
Change in Working Capital, £m	**(16.9)**	**13.0**	**(3.7)**	**(16.4)**	**(25.3)**
Change in Provisions, £m	(0.3)	(4.9)	(0.6)	8.8	(3.8)
Net Current Assets (ex Net Debt) % Gross Revenue	6.3%	4.4%	5.2%	5.0%	6.9%
Δ Working Capital % Gross Revenue	**(2.2%)**	**1.5%**	**(0.4%)**	**(1.5%)**	**(2.0%)**
Δ Working Capital % Δ Gross Revenue	(15.0%)	12.7%	(3.3%)	(10.6%)	(17.6%)

Source: SThree PLC, Radnor Capital Partners

The key issue for investors seeking comfort on revenue recognition will be to understand the variances between SThree's P&L and Cashflow statements. We can see from Figure 1 above that the core relationship between working capital investment and gross revenue growth has held true for SThree in four of the five last years.

All things being equal; growth in gross revenue (especially growth in Contract gross revenue) will result in Receivables growing at a faster rate than Payables and therefore consuming cash. Over the last five years, SThree has grown gross revenue by £623m for a net working capital cash investment of £49.3m.

We can also see that the utilisation / release of provisions through the cashflow has been very low relative to invoice driven working capital movements. In fact, taken in aggregate over the last five years, net provision movements have totalled a cash outflow (P&L benefit) of only £0.8m.

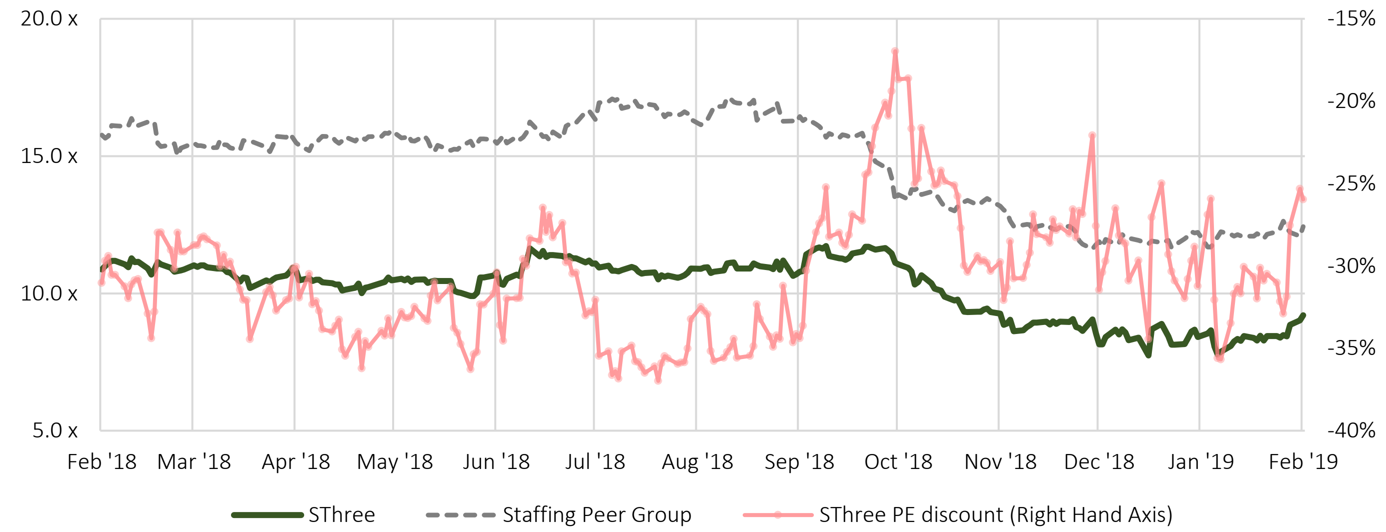
FY2018 does represent a larger than normal working capital outflow of £25.3m (or 17.6% of the growth in gross revenue). However, FY2018 did see SThree move its entire group support, finance and back office functions from London to Glasgow. This was a major exercise and did have an expected impact on the invoice and collections cycle. SThree has indicated that c.60% of the working capital outflow reported in FY2018 is due to this short-term impact of the move to Glasgow and would be expected to normalise through the course of FY2019E. If we adjust the £25.3m for this impact, the working capital outflow would have been £15.2m, or 10.6% of the growth in gross revenue, consistent with FY2017.

The travails at Staffline have sharpened investor focus on revenue recognition policies. We believe SThree does not raise any concerns in this regard with a simple and clear approach to revenue recognition. Variances between the P&L and cashflow are consistent with the commercial substance of the SThree business model and display the characteristics we would expect to see.

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.

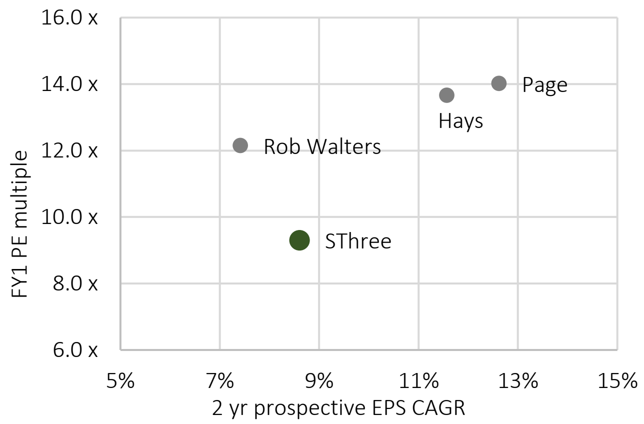
SThree prospective PE relative to Staffing peer group



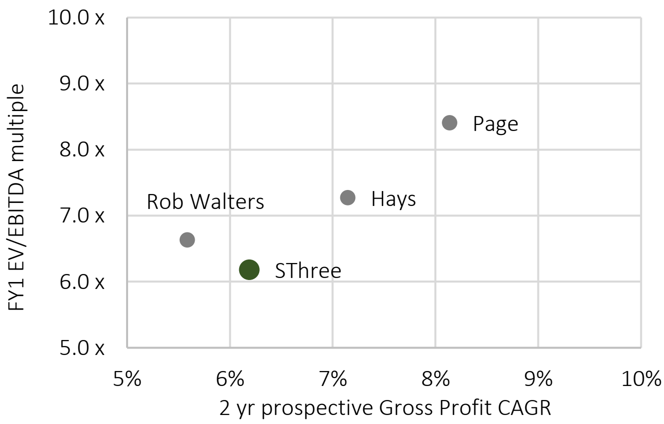
Source: FactSet, Radnor

We can see the effect of recent volatility, with the SThree discount narrowing from the 35% recorded in early January. We are mindful that markets remain febrile and sensitive to macro / political newsflow over the coming months. However, the materiality of the SThree share price recovery (+21% from its recent low) does suggest that the market has digested the strong FY2018 performance and is taking a more sanguine view on the outlook.

UK Staffers - EPS Growth vs PE multiple



UK Staffers – Gross Profit Growth vs EV/EBITDA



Source: FactSet, Radnor

The headline differentials between the individual company valuation metrics can be seen in the above charts. Comparing PE and EV/EBITDA multiples to two year prospective Gross Profit and Earnings growth shows SThree as the lowest rated stock even though it is expected to deliver faster EPS/Gross Profit growth than Robert Walters (RWA). This would also seem to ignore the argument that SThree's earnings are likely to be more resilient than all of its peers in the face of any cyclical slowdown.

Key Points – Investment Case

Market Blues

Professional Staffing stocks in the UK have 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 249p, down from a 52-week high of 385p. The shares have rebounded suggesting that investor sentiment is beginning to stabilise.

Positive Trading

The final results confirmed the better than initially expected outcome for 2018. Although not immune to macro headwinds; SThree is likely to enjoy higher levels of visibility compared to its Perm heavy peers and enjoyed a strong finish to 2018. SThree has seen consistent **upgrades** from the house brokers (UBS & Liberum) throughout the last two years.

Non-UK Exposure

85% 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

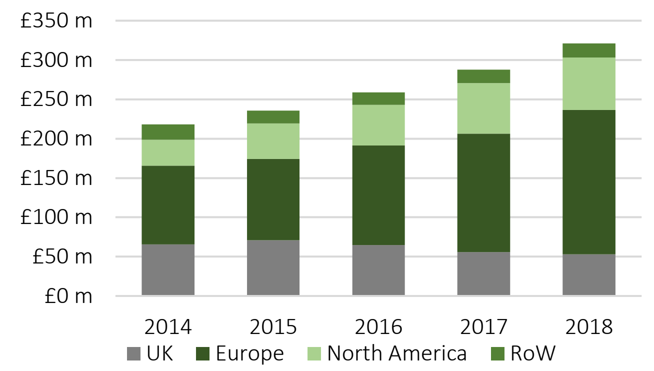
We believe investors have focused disproportionately on the performance of SThree's Permanent business in the UK, which is not a key value driver. The fundamental differences in business mix and strategic focus between SThree and its peers, in our view, have not been fully recognised. SThree is also 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% - 35% 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 9.3x and yield of 5.0% does not fully recognise SThree's growth and risk characteristics.

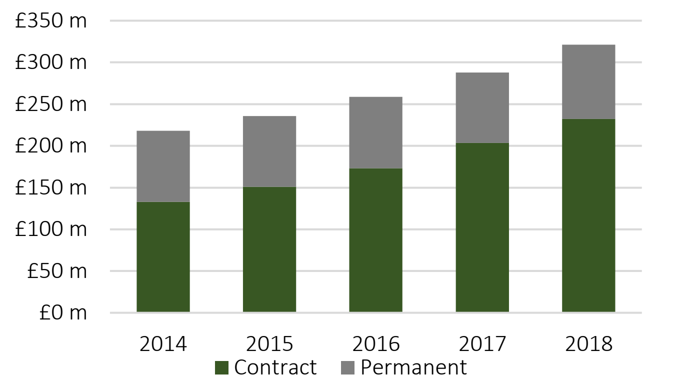
SThree - Key charts

Geographic Gross Profit 5 year track record



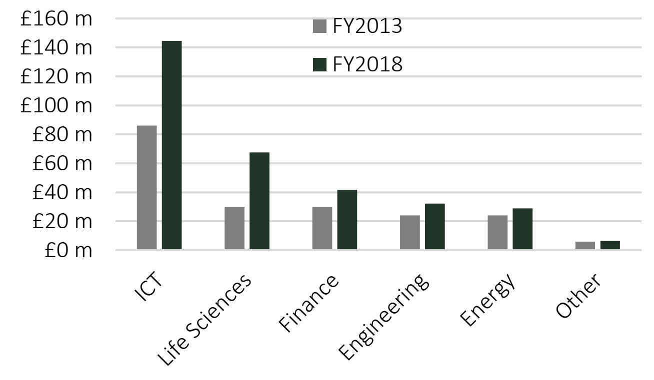
Source: FactSet, Radnor

Contract / Perm gross profit 5 year track record



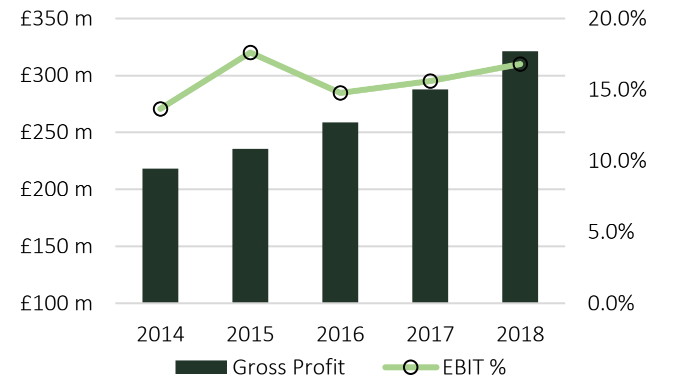
Source: FactSet, Radnor

STEM market gross profit 2013 vs 2018



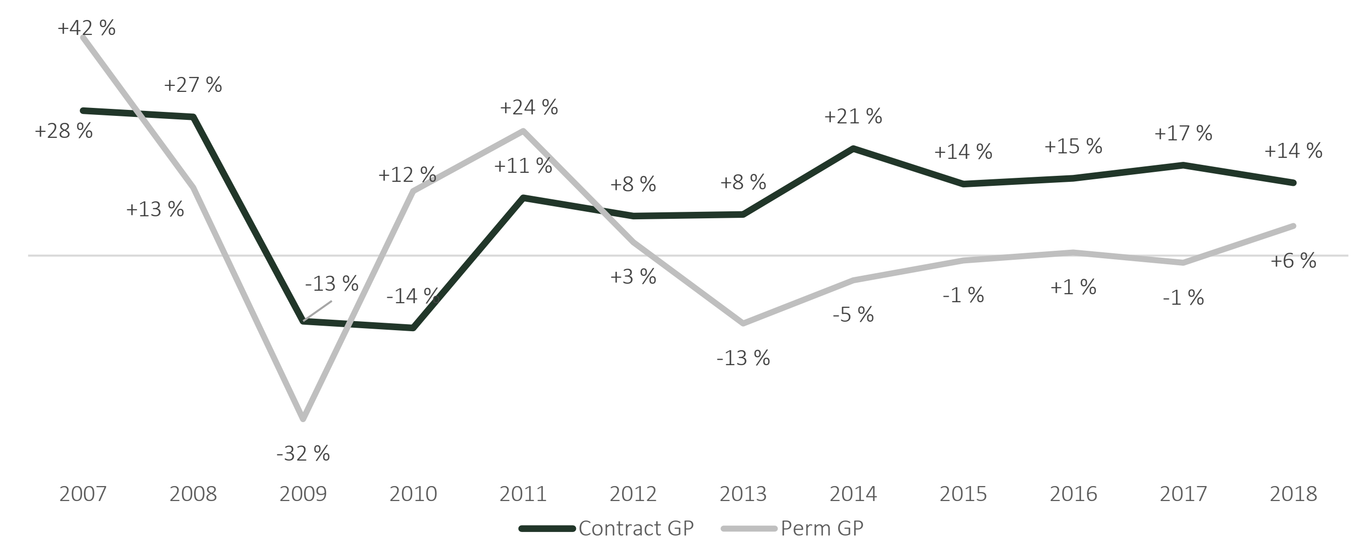
Source: FactSet, Radnor

Gross Profit and EBIT margins 5 year track record



Source: FactSet, Radnor

SThree Gross Profit growth – Contract vs Permanent



Source: Radnor

Key Estimates

SThree PLC

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Price (p): **306 p**
Market Cap: 400 m
EV: 404 m

PROFIT & LOSS

Year to 31 November, £m	2016	2017	2018	2019E	2020E	2021E
Group Sales	**960.0**	**1,114.5**	**1,258.2**	**1,360.1**	**1,437.0**	**1,510.3**
Europe	*126.8*	*150.6*	*183.4*	*203.5*	*217.8*	*230.9*
UK	*64.7*	*55.7*	*53.1*	*51.5*	*51.5*	*51.5*
North America	*51.7*	*64.4*	*66.7*	*70.0*	*72.8*	*75.7*
Asia Pacific	*15.5*	*17.0*	*18.0*	*19.0*	*20.0*	*21.0*
Group NFI	**258.7**	**287.7**	**321.1**	**344.1**	**362.1**	**379.1**
Op. Exp.	(214.8)	(237.0)	(261.1)	(278.7)	(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

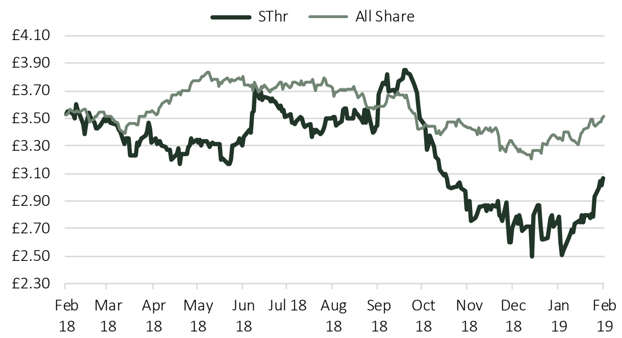
CASH FLOW

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)	(8.0)
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**	**55.2**	**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**	**39.8**	**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**	**33.8**	**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)	(1.6)	(3.0)	(3.0)	(3.0)
Net Cashflow	**3.8**	**(4.4)**	**(9.7)**	**11.5**	**11.0**	**22.7**
Net Cash (Debt)	**10.0**	**5.6**	**(4.1)**	**7.5**	**18.4**	**41.1**

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	306.1	330.4	347.1
Current Liabilities	(149.2)	(174.9)	(202.3)	(203.7)	(210.3)	(219.0)
Net Current Assets	**44.7**	**53.2**	**86.1**	**102.4**	**120.1**	**128.1**
Long Term Liabilities	(0.9)	(2.2)	(1.6)	(1.6)	(1.6)	(1.6)
Net Cash (Debt)	10.0	5.6	(4.1)	7.5	18.4	41.1
Net Assets	**75.7**	**80.7**	**101.7**	**129.9**	**159.1**	**190.6**

PRICE CHART - 1 YEAR ABSOLUTE vs FTSE ALL SHARE



Source: FactSet

SHAREHOLDERS

	% of ord. Share capital
JO Hambro Cap Mgmt	11.5%
SThree Founders	7.7%
Franklin Templeton	6.4%
Harris Assoc	5.3%
M&G	4.6%
Allianz Global	4.4%
JPMorgan Asset Management	4.4%
	44.3%

Announcements

Date	Event
2019-01-01	FY results FY 2018
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

RATIOS

	2017	2018	2019E	2020E	2021E
RoE	41.0%	38.8%	33.8%	29.8%	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%	28.1%	27.6%	28.1%	23.0%
Op Cash % EBITA	89.2%	55.8%	91.7%	87.0%	102.5%
Net Debt / EBITDA	0.2x	0.1x	-0.1x	0.1x	0.3x

VALUATION

Fiscal	2017	2018	2019E	2020E	2021E
P/E	12.3x	10.3x	9.4x	8.7x	8.3x
EV/EBITDA	8.0x	6.7x	6.2x	5.8x	5.5x
Div Yield	4.6%	4.7%	4.9%	5.1%	5.2%
FCF Yield	5.7%	2.5%	8.4%	8.5%	11.6%
Div Cover	1.8x	2.0x	2.2x	2.3x	2.3x
NFI growth	11.2%	11.6%	7.2%	5.2%	4.7%
EPS growth	18.4%	18.9%	10.0%	7.2%	5.6%
DPS growth	0.0%	3.6%	3.4%	3.3%	3.2%

REGULATORY DISCLOSURES

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