

1 Year Chart



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SThree has released a brief update ahead of the scheduled Q4 trading update expected on 14th December. The key headline is that an improving trading backdrop over the last few months has driven a better than expected profit performance. Market consensus was clearly too light with the company now guiding for an FY'20 outcome above the top end of the range of expectations. We have updated our forecasts accordingly and now look for FY'20 PBT and EPS of **£28.1m / 13.3p** respectively – a PBT upgrade of **+53%** on our previous estimate. Although the company has not formally reinstated full guidance, we are taking this opportunity to publish our estimates for FY'21.

SThree has shown good resilience through this pandemic. The combination of STEM industry specialism and the inherently higher short term visibility of the contract focus has afforded SThree management a greater degree of flexibility when it came to aligning the necessary cost actions with the strategic ambitions of building market share in the key, global STEM markets. Costs and headcount have been cut, but they have been targeted and selective. The net result has been an increasingly positive tone in trading commentary, culminating in yesterday's explicit upgrade.

Has this been fully priced in by the market? To an extent yes, with the shares now standing +57% above the May 2020 lows and outperforming the peer group year to date. However, despite this outperformance (share price and operational) SThree still stands at a material valuation discount to its peers. We continue to find the extent of this valuation gap hard to justify.

- **Trading update:** Although the US and Germany have been highlighted as particular areas of strength (consistent with earlier trading commentary); it seems clear that elsewhere in the group, net fees have held up better than first anticipated.
- **Margins have been the prime beneficiary:** Perhaps more so than the better than expected net fees performance; margins are the story of this update. Cost reductions have not impacted consultant productivity resulting in a strong drop through performance as the year has progressed.
- **Estimate upgrades:** We have upgraded our FY'20 PBT and EPS estimates by **+53% / +33%** respectively. We have also taken this opportunity to publish our FY'21 estimates. The FY'21 outlook remains cautious and is likely to be H2 weighted. We look for low single digit net fee growth but a continuing recovery in margins driving **+16% / +26%** growth in PBT / EPS respectively.

November, £m	Net Fees	PBT adj	EPS (p)	Div (p)	Net Cash	Fiscal PER x	Yield %
FY 2017A	287.7	44.5	24.9	14.0	5.6	13.1	4.3
FY 2018A	321.1	53.3	29.6	14.5	-4.1	11.0	4.4
FY 2019A	342.4	59.2	32.3	5.1	10.6	10.1	1.6
FY 2020E	306.2	28.1	13.3	3.0	39.4	24.7	0.9
FY 2021E	312.7	32.6	16.8	6.0	45.4	19.4	1.8

Source: Radnor Capital Partners

Estimate Revisions: PBT +53% for FY'20, re-introduced for FY'21

We have revisited our forecast model and have made the following changes:

Figure 1: Radnor estimate revisions

	FY'19A	Previous		New		Change, % FY'20E
		FY'20E	FY'21E	FY'20E	FY'21E	
Group Gross Revenue	1,345.0	1,098.0	-	1,224.6	1,250.8	+ 12%
Group Net Fees	342.4	274.5	-	306.2	312.7	+ 12%
EBITA	60.1	19.1	-	28.8	33.1	+ 51%
- margin %	17.6%	7.0%	-	9.4%	10.6%	
Adj. PBT	59.2	18.4	-	28.1	32.6	+ 53%
Adj. EPS (p)	32.3	10.0	-	13.3	16.8	+ 33%
Dividend (p)	5.1	-	-	3.0	6.0	
Net Cash (Debt)	10.6	22.2	-	39.4	45.4	+ 78%

Source: Radnor

- Net Fees** – a 12% upgrade to our FY'20 expectations with a sharper Q3 and Q4 recovery curve than originally expected. As the update has highlighted; the US and Germany have been notably strong relative to initial expectations and are clearly the two territories demonstrating the strongest short-term momentum. However, the rest of the group is likely to have played a part and we would expect the more detailed Q4 trading update commentary here to paint a picture of a material year on year decline, but not as severe as had been planned for.
- Margins** – SThree is not alone amongst a number of superficially cyclical stocks that have reported a materially better than expected profit performance during the latter stages of the pandemic. We note a number of positive recent trading commentaries from the media sector painting a similar picture. Not only has SThree benefited from the initial costs actions undertaken earlier on in the pandemic; but the emphasis on selective, rather than general, headcount reductions have kept capacity in place to be able to take advantage of the pockets of strength that, clearly, still do exist.

We also note the reference to the closure of the Australian business, which was announced at the last trading update. Although the detail is not provided in this update, our working estimate would be between £1m and £2m as a realistic cost range. These costs are likely to be fully expensed (ie, not taken as an exceptional) and this would suggest that the underlying EBIT margin is closer to 10%.

- Balance Sheet** – We have explored SThree's defensive working capital characteristics in more detail in past research, but we note another upgrade to

our net cash expectations to £39.4m for FY'20 as the combination of working capital release and increased profitability continue to flow through.

SThree were quick to secure the balance sheet during the early stages of the pandemic (including drawing down the RCF) and yet has found itself in the position of having the confidence to reverse the RCF drawdown and also repaying furlough monies in the UK.

We are pencilling in a tentative 3p final dividend to reflect the resilience of the balance sheet but we are mindful that the company has yet to provide any specific guidance on the shape and quantum of any resumption of dividend payments.

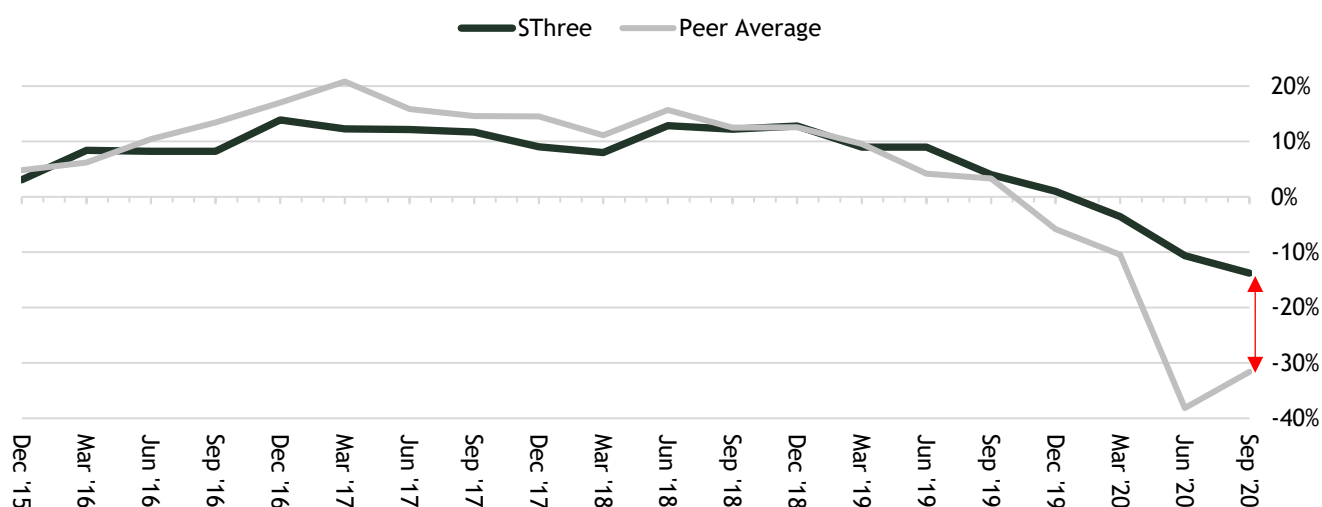
The critical point is that SThree, unlike its perm heavy peers, is not a short-term transactional business. SThree earns its fees over the duration of a contract placement (typically nine months), and not in one go at the point of initial placement, requiring SThree to fund its contractors up front before being paid by clients. This creates two dynamics that are critical against a volatile environment.

1. **Room for manoeuvre:** SThree is the only listed recruiter where revenues have not fallen off a cliff. Management have been able to, consistently, take a more measured approach, more consistent with longer term strategic ambitions around targeted market share gains, to their cost responses as a result.
2. **Visibility:** Although not subscription revenue per se; SThree's revenues are longer term, and more likely to see a material level of repetition, than their more transactional, shorter term peers. These subscription characteristics to the business model imply a less volatile margin / conversion ratio. There is an argument here around a higher "quality" of earnings and whether this justifies a material valuation discount.

Performance relative to the peer group

Below, we update our peer group comparison charts looking at both total net fee trends and perm / contract mix.

Figure 2: Quarterly Net Fee trends, YoY growth – SThree vs UK Staffing peer group average



Source: FactSet, Radnor

In Figure 2 above, we show the extent to which SThree's overall net fees performance has held up relative to the peer group (Hays, PageGroup and Robert Walters). As at the last quarter (whilst acknowledging a 1 month differential between SThree's reporting period versus the others), the differential stood at +18% in SThree's favour. We note that the gap between SThree and the peer group has never been in excess of 10% (positive or negative) since 2015, with 2020 marking a material decoupling.

In Figures 3 and 4 below, we compare SThree's contract and permanent YoY net fee trends with Hays and Page (for whom quarterly perm / temp splits are available).

Figure 3: Contract Net Fees, YoY growth

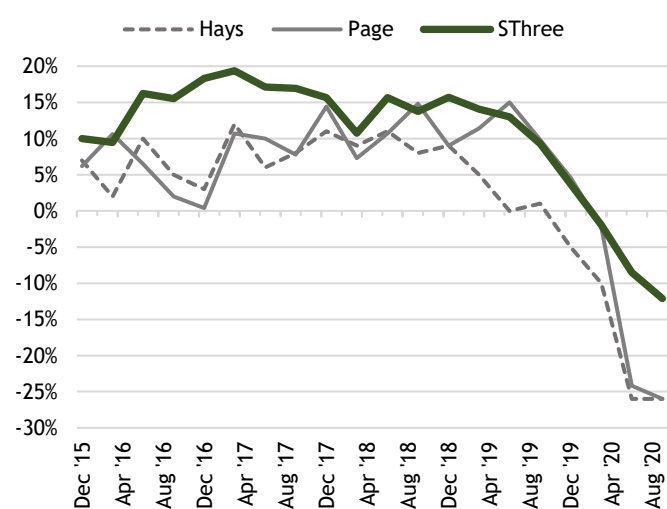
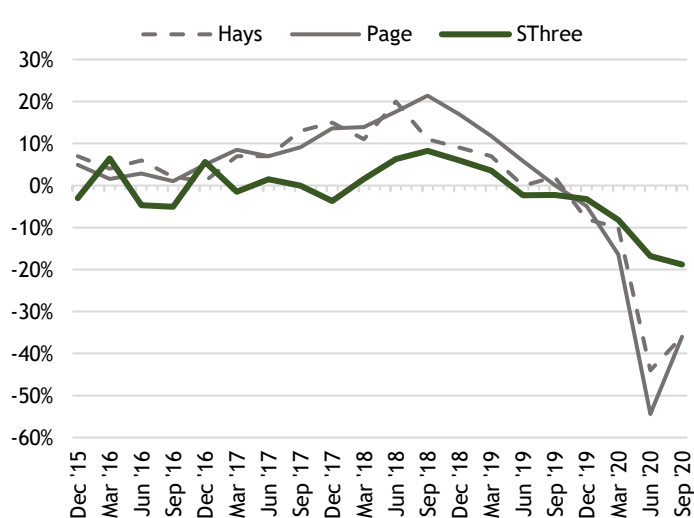


Figure 4: Perm Net Fees, YoY growth



Source: FactSet, Radnor

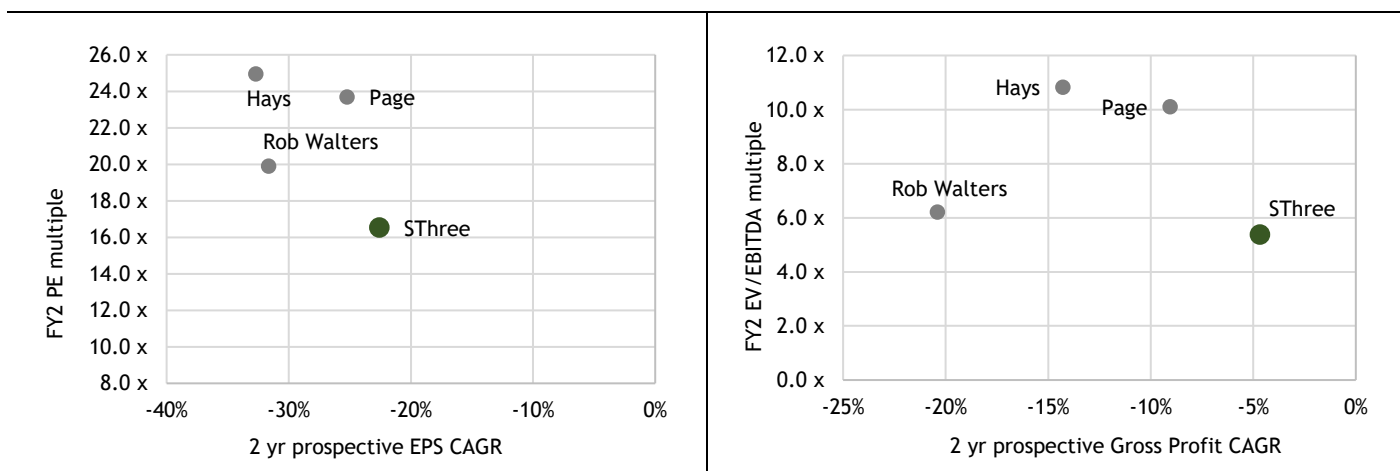
Unsurprisingly, SThree has seen its most pronounced outperformance in the Contract business. However, we do note that peer trading commentary have highlighted Technology, Engineering and Life Sciences as being areas of relative strength in their own businesses; although their own Contract net fee trends remain significantly worse than SThree's.

The Permanent picture is perhaps more surprising with SThree also outperforming the peer group in an area that is not the company's primary strategic focus. We would make two key observations here:

1. Firstly, both Germany and the US are the largest perm businesses in the group and have benefited from the relative robustness of those markets.
2. Secondly, SThree's strategic focus on STEM industries and roles will have provided the Permanent businesses with a degree of protection from the worst cyclical effects of the downturn as these industries have, by and large, outperformed their domestic economies.

Valuation

Figure 5 & 6: SThree FY2 PE and EV/EBITDA multiples vs Staffing peer group average (Consensus based)

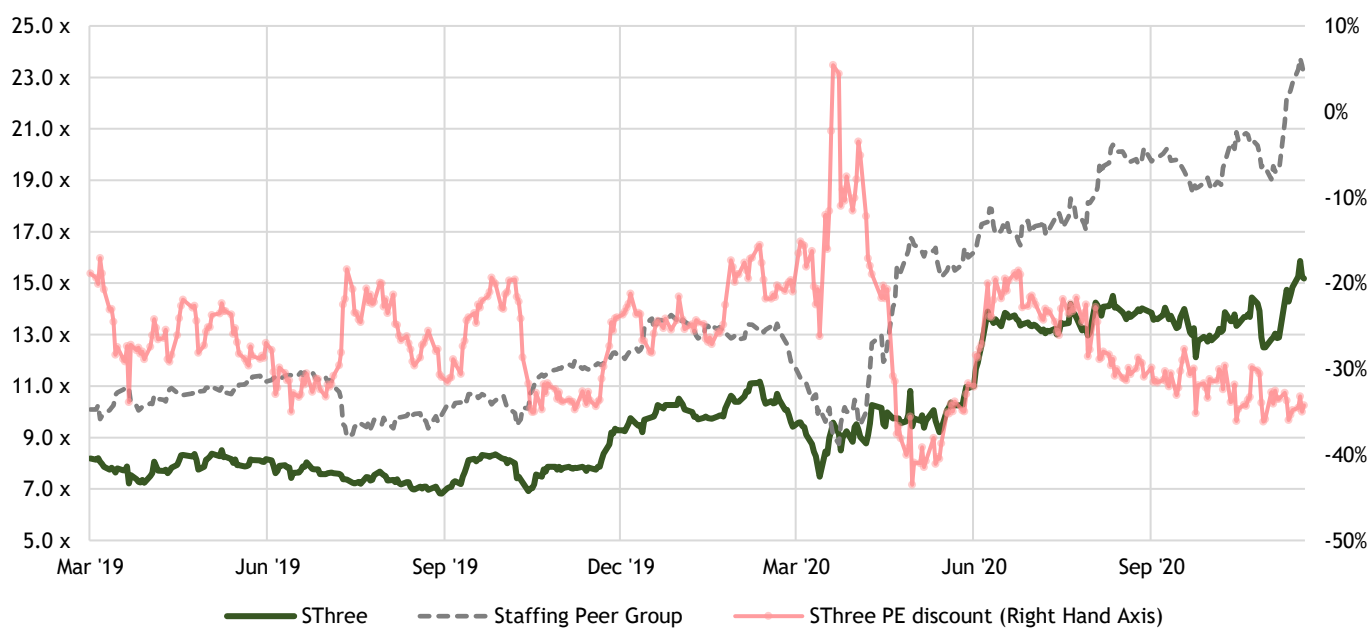


Source: FactSet

Both the charts above, illustrate the same point. SThree continues to trade at a discount to its UK listed peers (on both two year forecast PE and EV/EBITDA) despite offering the most resilient EPS and Net Fees profile in the peer group.

In Figure 7 below, we show how the FY2 PE multiple for both SThree and the peer group has evolved since March 2019. Despite the consistent, upwards re-rating SThree has experience since June 2020 (7.0x to 15.2x), this has been more than matched by the peer group where EPS downgrades have been more consistent but not matched by share price.

Figure 7: FY2 PE multiple evolution – SThree vs UK Staffing peer group average (consensus based)



Source: FactSet

SThree PLC

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Price (p): 327 p
Market Cap: 442 m
EV: 403 m

PROFIT & LOSS

Year to 31 November, £m	2016	2017	2018	2019	2020E	2021E
Group Sales	960.0	1,114.5	1,258.2	1,345.0	1,224.6	1,250.8
Group Net Fees	258.7	287.7	321.1	342.4	306.2	312.7
Op. Exp.	(214.8)	(237.0)	(261.1)	(276.3)	(271.0)	(273.0)
EBITDA	43.9	50.7	60.1	66.1	35.2	39.7
Depr & Amort	(5.7)	(5.7)	(6.1)	(6.0)	(6.4)	(6.6)
EBITA - Adjusted	38.2	44.9	53.9	60.1	28.8	33.1
Associates & JV's	-	(0.1)	0.1	0.1	0.1	0.1
Net Bank Interest	(0.5)	(0.3)	(0.7)	(1.0)	(0.8)	(0.6)
PBT - Adjusted	37.7	44.5	53.3	59.2	28.1	32.6
Non Operating Items	-	(6.7)	(8.3)	-	-	-
Other Financial Items	-	-	-	-	-	-
PBT - IFRS	37.7	37.8	45.0	59.2	28.1	32.6
Tax - Adjusted	(9.9)	(11.4)	(13.9)	(15.9)	(10.4)	(10.1)
<i>Tax rate - Adjusted</i>	<i>26.3%</i>	<i>25.6%</i>	<i>26.0%</i>	<i>26.9%</i>	<i>37.0%</i>	<i>31.0%</i>
Minority interests	-	-	-	-	-	-
No. shares m, diluted	132.0	132.6	133.1	133.6	133.6	133.6
Adj EPS (p), diluted	21.1	24.9	29.6	32.3	13.3	16.8
Total DPS (p)	14.0	14.0	14.5	5.1	3.0	6.0

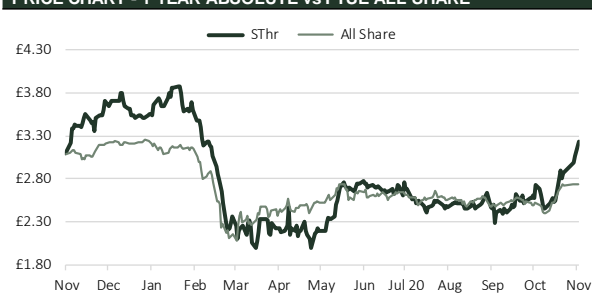
CASH FLOW

Year to 31 November, £m	2016	2017	2018	2019	2020E	2021E
EBITDA	43.9	50.7	60.1	66.1	35.2	39.7
Working Capital	(4.3)	(16.4)	(25.3)	(11.7)	18.4	(8.0)
Provisions / Exceptionals	2.6	5.8	(4.7)	(1.3)	(1.5)	(1.5)
Gross Op Cashflow	42.2	40.1	30.1	53.1	52.1	30.3
Cash Tax	(8.5)	(10.9)	(14.4)	(13.0)	(11.1)	(15.2)
Cash Intererest	(0.5)	(0.3)	(0.5)	(1.0)	(0.8)	(0.6)
Net Op Cashflow	33.2	28.9	15.2	39.1	40.2	14.5
Capex	(6.1)	(5.8)	(5.2)	(4.5)	(4.5)	(4.5)
Free Cashflow	27.1	23.1	10.0	34.6	35.7	10.0
Dividends	(18.0)	(18.0)	(18.0)	(18.8)	(6.8)	(4.0)
Acquisitions & Inv.	(0.7)	(1.2)	-	-	-	-
Other Non Operating	(4.6)	(8.3)	(0.2)	1.4	-	-
Net Cashflow	3.8	(4.4)	(8.2)	17.2	28.9	6.0
Net Cash (Debt)	10.0	5.6	(4.1)	10.6	39.4	45.4

BALANCE SHEET

Year to 31 November, £m	2016	2017	2018	2019	2020E	2021E
Intangibles	11.6	11.4	9.6	8.0	8.0	8.0
P,P+E	7.1	6.7	6.9	6.8	8.7	10.8
Tax Asset & Other	3.2	6.0	4.7	4.2	4.2	4.2
Total Fixed Assets	21.9	24.1	21.3	19.0	20.9	23.0
Current Assets	193.9	228.1	288.4	271.0	239.4	244.5
Current Liabilities	(149.2)	(174.9)	(202.3)	(182.4)	(169.2)	(166.3)
Net Current Assets	44.7	53.2	86.1	88.6	70.2	78.2
Long Term Liabilities	(0.9)	(2.2)	(1.6)	(1.4)	(1.4)	(1.4)
Net Cash (Debt)	10.0	5.6	(4.1)	10.6	39.4	45.4
Net Assets	75.7	80.7	101.6	116.8	129.1	145.1

PRICE CHART - 1 YEAR ABSOLUTE vs FTSE ALL SHARE



Source: FactSet

SHAREHOLDERS

	% of ord. Share capital
JO Hambro Cap Mgmt	9.1%
SThree Founders	7.6%
Harris Assoc	5.0%
M&G	4.8%
Allianz Global	4.2%
Premier Miton	3.6%
Littlejohn & Co	3.5%
	37.8%

Announcements

Date	Event
14 September 2020	Q3 trading update
20 July 2020	Interim results
15 June 2020	Q2 trading update
20 May 2020	Access to CCFF and Covid-19 update
06 April 2020	Covid-19 update
16 March 2020	Q1 trading update

RATIOS

	2017	2018	2019	2020E	2021E
RoE	41.0%	38.8%	37.1%	13.7%	15.5%
RoCE	59.6%	51.1%	56.7%	32.2%	33.3%
Asset Turnover (x)	0.1x	0.1x	0.1x	0.1x	0.1x
NWC % Revenue	16.5%	28.1%	22.8%	10.1%	10.5%
Op Cash % EBITA	89.2%	55.8%	88.4%	180.9%	91.4%
Net Debt / EBITDA	0.2x	0.1x	-0.1x	0.2x	1.1x

VALUATION

Fiscal	2017	2018	2019	2020E	2021E
P/E	13.1x	11.0x	10.1x	24.7x	19.4x
EV/EBITDA	7.9x	6.7x	6.1x	11.4x	10.1x
Div Yield	4.3%	4.4%	1.6%	0.9%	1.8%
FCF Yield	5.7%	2.5%	8.6%	8.9%	2.5%
Net Fees growth	11.2%	11.6%	6.6%	-10.6%	2.1%
EPS growth	18.4%	18.9%	9.1%	-59.0%	27.1%
DPS growth	0.0%	3.6%	-64.8%	-41.2%	100.0%

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