SThree PLC

STEM | Small Cap | Support Services | 363p | £486m

Q3 update – H1 momentum maintained, further upgrades

1 Year Chart

SThree's scheduled Q3 update has painted a reassuring picture of sustained, positive net fee momentum despite a challenging macro backdrop. The consistency of growth, from across the breadth of the group and against the context of tough, non-Covid impacted, comparatives is striking.

Although headcount investment is gathering pace (in line with management guidance), productivity remains elevated (+5% in Q3), a consistent feature of SThree's impressive post pandemic performance. The net result is a full year outcome expected to be 7% ahead of current consensus. We therefore upgrade our FY22 net fee / PBT estimates by 3% / 7% respectively. The shape of previously announced investments, coupled with a natural caution around the outlook, leads us to a smaller 1% / 3% upgrade to our FY23 estimates.

Although the market responded positively to the update and upgrade (shares +4% on the day), the SThree share price is down c.21% year to date (peer group down 27%) despite a combined c.30% earnings upgrade delivered YTD. The close correlation between SThree's forward valuation and that of the UK Staffing peer group suggests a market that sees little difference between them. For us the evidence of SThree's operational outperformance is clear and we continue to believe a premium valuation for SThree is more than warranted

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

- **Positive momentum maintained:** Q3 YoY net fee growth came in at +19%, compared to 25% for H1 and 23% for Q2. Growth was strong across all key markets and disciplines. ECM continues to grow as a proportion of the group.
- **Contractor order book continues to underpin the outlook:** A key, but often ignored, differentiator for SThree is the degree of forward visibility it enjoys compared to other staffers. The Contractor Order Book (COB) continues to grow and is now +24% YoY despite strong, post Covid comparatives now in play.
- **Productivity gains continue but will begin to revert:** Although headcount growth (as previously guided by management) is picking up, SThree continues to benefit from elevated productivity as record net fees are serviced by headcount levels that remain below pre Covid levels. We continue to expect margin growth to slow in the short term as this dynamic normalises but the pathway to sustaining longer term margin gains is becoming clearer.
- **Estimate upgrades.** At the interims we upgraded EPS (+5%) but kept net fee / EBIT estimates unchanged. As anticipated, we now upgrade net fees (+3%) and EBIT (+7%) in response to the group's continued strong trading. It is too early to roll through fully into FY23, where we upgrade PBT by a more modest +3%.

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November, £m	Net Fees	PBT adj	EPS (fully diluted,p)	Div (p)	Net Cash	Fiscal PER x	Yield %
FY 2020A	308.6	30.1	13.5	5.0	49.9	26.9	1.4
FY 2021A	355.7	60.0	30.8	11.0	57.5	11.8	3.0
FY 2022E	*423.5*	*76.3*	*40.1*	*16.0*	*57.2*	*9.0*	*4.4*
FY 2023E	*445.7*	*81.4*	*42.0*	*16.8*	*73.5*	*8.6*	*4.6*
FY 2023E	*477.8*	*90.3*	*45.8*	*17.6*	*84.5*	*7.9*	*4.9*

Source: Radnor Capital Partners

Q3 trading update – Key highlights

- Q3 FY22 net fees **£111.8m (+19% YoY constant currency)** compared to Q2 FY22 net fees +23% YoY and H1 FY22 net fees +25%.

- The Q3 FY21 comparative was itself very strong (+21% vs Q3 FY20)

- The Contractor Order Book (the single best measure for forward visibility) ended Q3 **+24% YoY**

- **Contract** net fees (**77%** of the group total) grew +21% YoY, with double digit growth across all the group's key markets:

  → DACH **+18%**

  → EMEA (excl DACH) **+27%**

  → USA **+16%**

  → APAC **+41%**

- Within Contract, we also saw ECM growth continue to outstrip the more traditional contract service models. At the interim results, ECM represented 33% of overall Contract net fees and we expect this share to have grown further by the year end. ECM work is stickier, more complex and drives higher net fee margins than independent contracting.

- **Permanent** net fees (**23%** of the group total) grew +10% YoY

  → DACH +11% YoY

  → EMEA (excl DACH) +24% YoY

  → USA -10% YoY

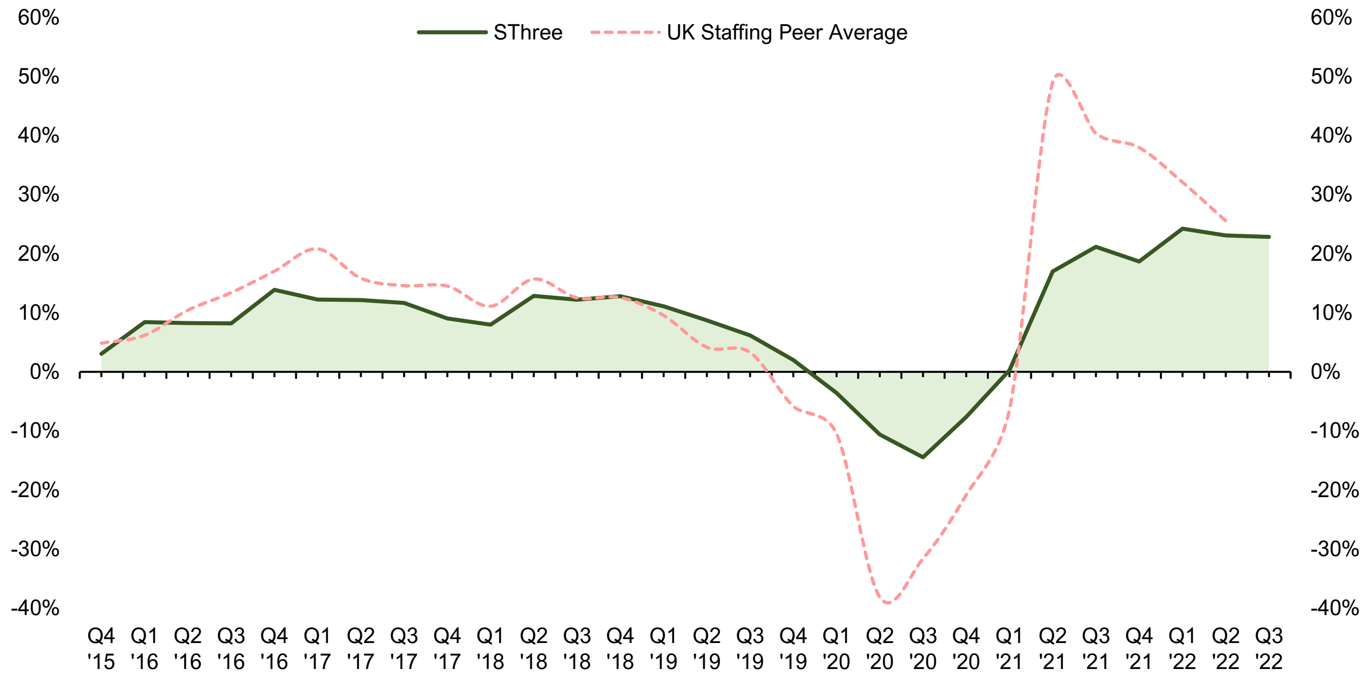
  → APAC +40%

- The 10% decline in US Perm (the only negative number across the breadth of the group) was driven primarily by a very strong Q3 FY21 comparative (+80% vs Q3 FY20), which was always going to be hard to beat given the impetus behind vaccine related Life Science hiring activity during FY21.

- Of SThree's larger regions; EMEA (excl DACH) is worth mentioning as growth here was driven primarily by the Netherlands (+36% driven by Engineering and Technology) and the UK (+25%). The UK continues to benefit from a period of good performance (five straight quarters of growth) following a restructuring of the business in FY20.

In Figure 1 below, we show the quarterly net fee track record for SThree and the UK Staffing Peer Group since Q4 2015. Due to the November year end, SThree is the first of the UK Staffing peer group to report and we await updates from the peer group with interest. We note that since Q3 2018, SThree has delivered stronger YoY quarterly net fee growth in 11 quarters out of 16.

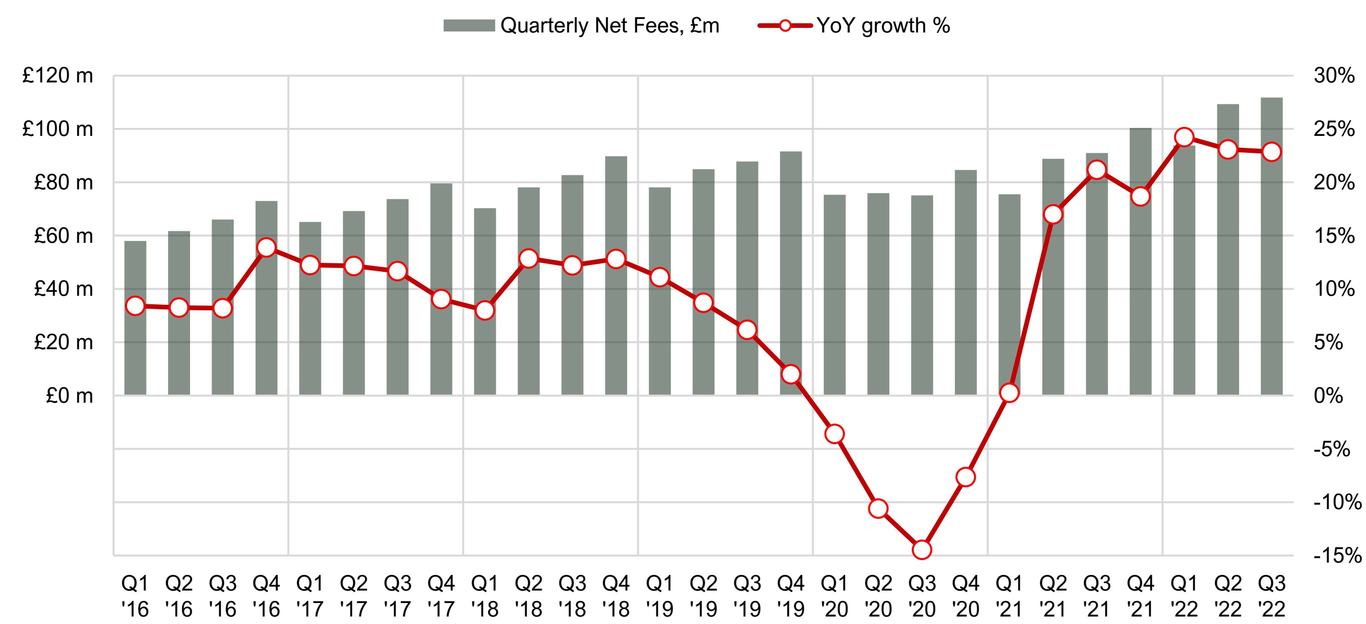
Figure 1: SThree net fee growth vs Peer Group



Source: FactSet, Radnor

In Figure 2 below, we show SThree in isolation. We can see from here that Q3 FY22 was a record quarter for the group in terms of net fees with Q2 FY21 the previous peak. Q4 is traditionally the strongest quarter for the group.

Figure 2: SThree quarterly net fee income since Q1 2016.



Source: FactSet, Radnor

Estimate upgrades: FY22 net fees +3%, PBT +7%

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 the H1 results, we further upgraded our FY22 EPS estimates (+6%) to reflect a lower tax rate (see link to this note here). Following management commentary around the expected full year outcome we are upgrading our FY22 net fee / PBT estimates by +3% / +7% respectively. We had flagged the likelihood of Q3 upgrades in our last note.

H1 margins are not sustainable in the short term …

Although we are ticking up our FY22 EBIT margin estimate (18.2% vs 17.5%), it is worth re-iterating our base case view around margins. H1 FY22 EBIT margins came in at an impressive 22% and it is clear that this level is unlikely to be maintained for the full year. Despite the tailwind of net fee growth, the cost headwinds of headcount investment and the well flagged internal investment costs have yet to fully wash through.

Guidance throughout the year has been for the investment costs 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. The "new" news from the Q3 update is that the H2 FY22 impact is now likely to be between £6m to £7m, still within the cost range guided but lower than our initial estimate. Interestingly, this cost reduction is not a case of shifting FY22 cost into FY23 but represents a smaller overall cost to complete.

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

We now look for FY22 EBIT margins to come in at 18.2%, +1.1% vs FY21. This implies an H2 EBIT margin of 14.7% 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 £6m - £7m of investment spend currently guided by the company, then this implies a pre-spend H2 FY22 EBIT of c.£39m (an underlying H2 margin of 17.7%) and full year underlying EBIT / margin of £83.5m / 19.7%. The ambition to deliver sustainable EBIT margins in excess of 21% by 2024 should be seen against this steadily improving underlying margin picture.

In Figure 3 & 4 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 3: 2 Year prospective PE multiple

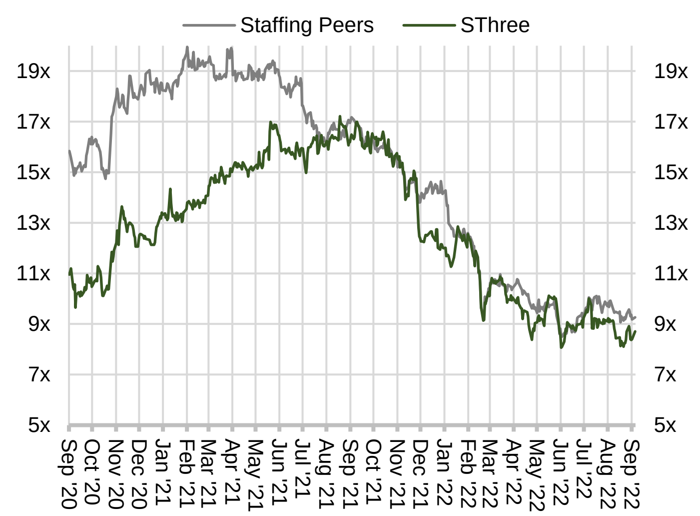
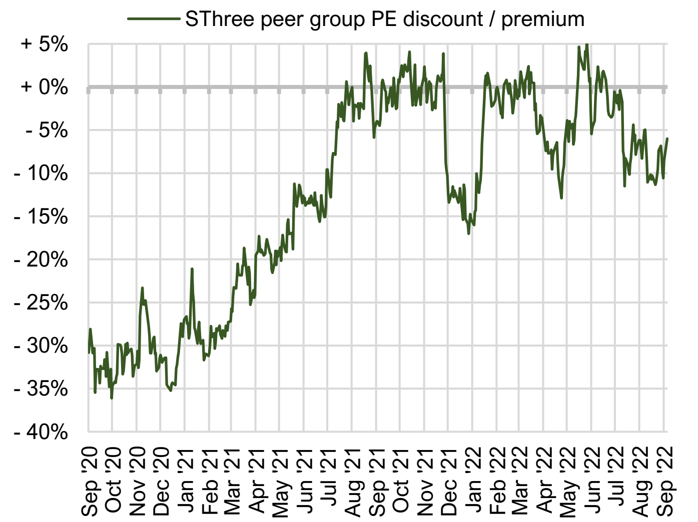


Figure 4: SThree PE discount / premium



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 9.0x / 8.6x respectively and a dividend yield of 4.4% / 4.6% 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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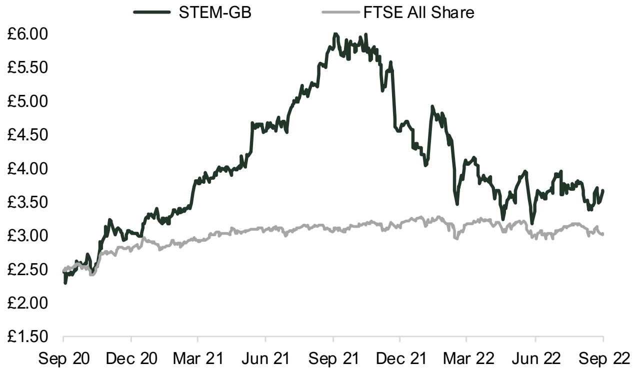
Price (p): **363 p**
Market Cap: 486 m
EV: 436 m

PROFIT & LOSS

Year to 31 November, £m	2020	2021	2022E	2023E	2024E
Group Sales	**1,202.6**	**1,330.7**	**1,694.0**	**1,782.8**	**1,911.1**
EMEA (ex DACH)	*117.6*	*127.2*	*153.9*	*160.1*	*169.7*
DACH	*105.8*	*129.4*	*152.7*	*161.9*	*174.8*
USA	*77.2*	*89.3*	*104.6*	*110.9*	*119.8*
APAC	*7.9*	*9.8*	*12.3*	*12.9*	*13.5*
Group Net Fees	**308.6**	**355.7**	**423.5**	**445.7**	**477.8**
Op. Exp.	(257.8)	(276.6)	(326.9)	(344.0)	(367.3)
EBITDA	**50.7**	**79.1**	**96.6**	**101.7**	**110.5**
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**	**77.0**	**82.1**	**90.9**
Associates & JV's	-	-	-	-	-
Net Bank Interest	(1.2)	(0.8)	(0.7)	(0.7)	(0.6)
PBT - Adjusted	**30.1**	**60.0**	**76.3**	**81.4**	**90.3**
Non Operating Items	(1.3)	-	-	-	-
Other Financial Items	-	-	-	-	-
PBT - IFRS	**28.8**	**60.0**	**76.3**	**81.4**	**90.3**
Tax - Adjusted	(11.7)	(17.9)	(21.4)	(23.6)	(27.1)
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**	**40.1**	**42.0**	**45.8**
Total DPS (p)	5.0	11.0	16.0	16.8	17.6

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	96.6	101.7	110.5
Working Capital	25.3	(26.6)	(42.0)	(20.0)	(30.9)
Provisions / Exceptionals	0.8	2.0	(0.8)	(0.8)	(0.8)
Gross Op Cashflow	**76.9**	**54.5**	**53.8**	**80.9**	**78.8**
Cash Tax	(10.5)	(16.8)	(17.9)	(21.4)	(23.6)
Cash Intererest	0.1	(0.9)	(0.7)	(0.7)	(0.6)
Net Op Cashflow	**66.5**	**36.9**	**35.2**	**58.8**	**54.5**
Capex	(5.3)	(2.6)	(6.0)	(6.0)	(6.0)
Free Cashflow	**61.2**	**34.2**	**29.2**	**52.8**	**48.5**
Dividends	(6.7)	(6.7)	(15.0)	(22.0)	(23.1)
Acquisitions & Inv.	-	-	-	-	-
Other Non Operating	(13.3)	(12.5)	(12.5)	(12.5)	(12.5)
Net Cashflow	**41.3**	**15.1**	**1.7**	**18.3**	**13.0**
Net Cash (Debt)	**49.9**	**57.5**	**57.2**	**73.5**	**84.5**

Announcements

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

RATIOS

	2020	2021	2022E	2023E	2024E
RoE	14.3%	26.6%	27.4%	24.3%	22.6%
RoCE	39.8%	60.4%	53.8%	50.1%	46.5%
Asset Turnover (x)	0.2x	0.1x	0.1x	0.1x	0.1x
NWC % Revenue	4.8%	6.0%	7.2%	7.9%	9.0%
Op Cash % EBITA	245.7%	89.6%	69.8%	98.5%	86.7%
Net Debt / EBITDA	1.0x	0.7x	0.6x	0.7x	0.8x

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	381.1	401.1	430.0
Current Liabilities	(179.5)	(218.4)	(259.5)	(259.4)	(257.4)
Net Current Assets	**57.9**	**79.6**	**121.7**	**141.7**	**172.6**
Long Term Liabilities	(26.0)	(24.0)	(24.0)	(24.0)	(24.0)
Net Cash (Debt)	49.9	57.5	57.2	73.5	84.5
Net Assets	**128.5**	**158.1**	**200.4**	**237.4**	**279.9**

VALUATION

Fiscal	2020	2021	2022E	2023E	2024E
P/E	26.9x	11.8x	9.0x	8.6x	7.9x
EV/EBITDA	8.6x	5.5x	4.5x	4.3x	3.9x
Div Yield	1.4%	3.0%	4.4%	4.6%	4.9%
FCF Yield	14.0%	7.9%	6.7%	12.1%	11.1%
Net Fees growth	-8.7%	15.3%	19.1%	5.2%	7.2%
EPS growth	-58.3%	128.6%	30.2%	4.8%	8.9%
DPS growth	-2.0%	120.0%	45.9%	4.8%	4.8%

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