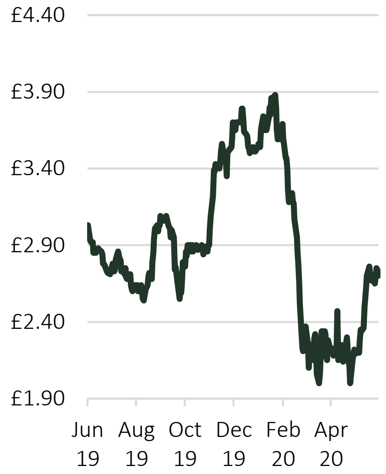
SThree PLC

STEM | Small Cap | Support Services |270p |£359m

1 Year Chart



SThree's H1 update has underlined, in equal measure, both the extent of the Coronavirus impacts but also the resilience of the SThree business model. In headline terms net fees were solid in Q1 and came under material pressure in Q2. However, our sense is that the 12% YoY decline in Q2 was better than the market would have been expecting. Impacts varied considerably across the group, which also underlines the geographical breadth of the business and the localised effects within the STEM niches that SThree serves.

It is clear SThree has responded to the pandemic in a nuanced and differentiated fashion. Despite headcount reductions (-5% Q2 vs Q1) we do not see a "slash and burn" approach that has typified others. Heading into the crisis, SThree had been in strategic growth and investment mode in response to structural drivers (STEM and flexible working) that remain very much in place. Management response to the crisis has been to protect the business whilst not sacrificing these growth opportunities.

The resilience of the business model can also seen through the growing strength of the balance sheet as a result of specific management action but also the natural working capital release of the contract business model. Net cash of £31m and £136m of total available liquidity positions SThree securely for the second half.

24th June 2020

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

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

Down, but by no means out

- **Net fee resilience:** Ultimately. SThree is the sum of the geographies and STEM specialisms it serves. Although the crisis has been broad in its reach; the effects (and timing of these effects) have not been uniform and we can see this in the spread of performance seen across the group. We would continue to expect Q3 to represent the near term trough but would anticipate SThree outperforming its UK listed peer group through the duration of the crisis.
- **Management actions.** We believe that this crisis will put clear blue water between SThree and its peers. The SThree management response has been anything but knee jerk and cost actions have been carefully targeted and localised. Critically, they have been framed by the longer-term strategic growth ambitions. Although, we would expect to see further headcount reductions through Q3, we do not see these as being uniform across the group.
- **Balance sheet security:** the growing net cash position (£31m) underlines the natural defensiveness of the SThree model. Although partly due to the natural partial unwinding of the working capital position; management also responded quickly to the unfolding crisis with extra internal resource redeployed to working capital management at a very early stage.

YE – November	Net Fees, £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	10.9	5.2
FY 2018A	321.1	53.3	29.6	14.5	-4.1	9.1	5.4
FY 2019A	342.4	59.2	32.3	5.1	10.6	8.4	1.9
FY 2020E	*274.5*	*18.4*	*10.0*	-	*22.2*	*27.0*	-
FY 2020E	-	-	-	-	-	-	-

Source: Radnor Capital Partners

H1 trading highlights

The key highlights from the H1 trading update (15th June, link here), were as follows:

- Group net fees for the six months ended 31st May 2020 was down 7% YoY at £151.2m;
- Breaking down by quarter; Q1 was largely unaffected by the coronavirus pandemic with net fees flat YoY, while Q2 net fees were down 12% YoY
- Despite the initial coronavirus impacts in Q2; the broad shape of the Contract business outperforming Permanent has remained consistent;
  - (i) Contract net fees in H1 were down 5% YoY to £114.6m (Q1 +2% YoY; Q2 -11% YoY),
  - (ii) Permanent net fees in H1 were down 12% YoY to £36.6m (Q1 -6% YoY, Q2 -17% YoY)
- We explore the detailed geographical and industry performance in more detail below.
- Net cash at 31st May of £31m, compared to £9m of net cash in February 2020 and net debt of £8m in May 2019. This strong cash performance has been driven by a combination of:
  - (i) The natural release of the working capital invested in the Contract book;
  - (ii) Management focus on working capital management and debtor collections. In a relatively short period of time SThree has been able to reduce Days Sales Outstanding from 45 at the end of Q1 2020 to 42;
  - (iii) Cash conservation measures around discretionary capital expenditure and tax payment deferrals;
- Following on from the 20th May announcement relating to SThree's eligibility for the BoE's Covid Corporate Financing Facility, this more recent trading update has given further colour on SThree's financing and liquidity position.
  - (i) Total accessible liquidity of £136m
  - (ii) Alongside the headline group net cash position, SThree has fully drawn the £50m RCF
  - (iii) Undrawn and available facilities include a £5m overdraft facility; the £50m CCFF facility. SThree also has a £20m accordion facility.
  - (iv) The £136m of immediate does not include the substantial net working capital position representing balances due from clients. At the last reported balance sheet date, this net working capital position amounted to c.£96m. A portion of this will have unwound and the H1 balance sheet will confirm the full extent, but we would anticipate a material working capital buffer (c.£80m) to remain.

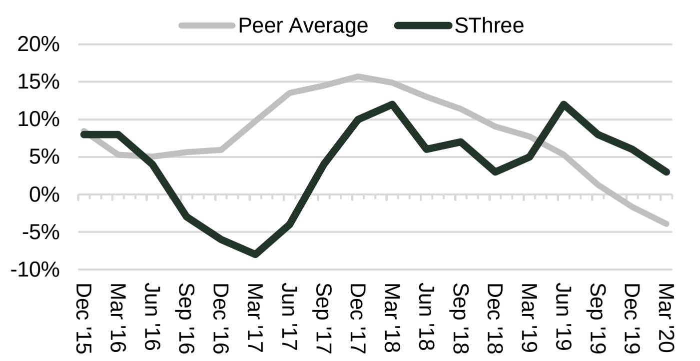
A Tale of Two Quarters

Although it goes without saying that the first two quarters of 2020 have been somewhat extraordinary; the broader context is worth revisiting for SThree in particular.

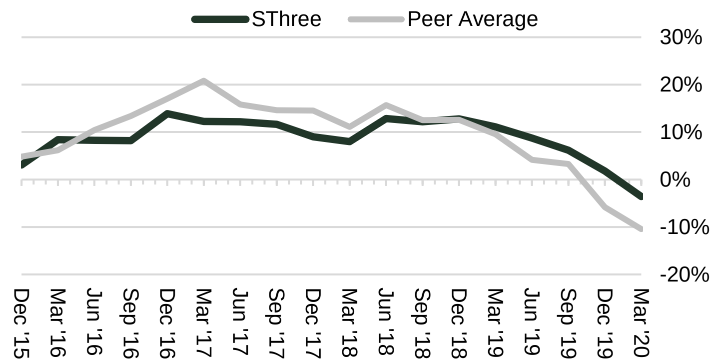
As we explored in our last research note (*14th April, Short term action; growth ambition undimmed*), SThree entered the Covid-19 crisis in rude health and had been the only major UK staffing business still investing in headcount growth. SThree had also been outperforming the peer group in terms of net fee momentum for the majority of calendar 2019. The two charts below are worth repeating as they illustrate the extent of the divergence between SThree and the peer group.

It is worth highlighting that SThree is the first of the listed peer group to report, so we await the news-flow from others. Our clear expectation is that net fee and headcount declines will be more pronounced across the peer group.

Headcount growth relative to UK Staffing peer group



NFI trends relative to UK Staffing peer Group



Source: FactSet, Radnor

Although the H1 trading update gave a full update on net fees, we will have to wait until the interim results themselves (expected in mid-July) to get the complete picture further down the P&L.

It has always been clear that the net effect of this investment in headcount was always going to challenge H1 FY20 profitability as FY 2019 investments fully annualise leading into H1 FY20. Clearly, the immediate challenges posed by Covid-19 will see this headcount growth reverse, and sequentially there was a 5% headcount decline Q2 vs Q1 2020, although the effects were not uniform across the group.

We believe this is likely to be one of the key differentiators between SThree and other UK listed staffers over the course of this pandemic. Although SThree has, quite rightly, taken active actions on operating costs and headcount, the message has been clear that these actions have been undertaken on a highly targeted basis and have been framed by the key strategic objectives outlined at last year's Capital Markets Day. Key long-term growth markets like the US and Germany, are unlikely to see the same level of cost actions as other areas where the structural growth opportunity is less pronounced.

Fundamentally, SThree has positioned itself squarely at the centre of two broad, long term trends around the growth of flexible working and growing demand for technical skills, which remain in short supply. Despite the severity of the short-term shock Covid-19 has created, these long-term trends will remain in place, or even accelerate. The key challenge for management is to strike the appropriate balance between protecting short term profitability and retaining the capacity to grow post crisis.

As we have flagged in our previous research, SThree had a creditable Q1 20, with group net fees flat YoY, in line with our expectations. Q1 Contract net fees were + 2% YoY.

SThree's robust performance in Q1 has been outweighed by the pandemic in Q2 across all territories and sectors. COVID-19 of course became a very meaningful factor in the world economy from mid March onwards. US and UK GDP estimates for April show monthly falls of about 11% and 20% YoY respectively, with the pace of contraction in Q2 unlikely to improve materially until the combination of fiscal and monetary stimulus and lock down easing fully feeds through. It is also worth highlighting that these effects are not synchronised with different geographies responding according to very different timelines and scale of government response.

In this broader economic context, the Q2 12% YoY decline in SThree net fees should be no surprise. If anything, we believe this number will have been better than the broader market would have been expecting.

As we highlight below, there are important regional variations in Group performance. However, there is no doubt that overall forward visibility remains extremely limited. It is therefore no surprise that SThree is not yet reintroducing any formal earnings guidance.

Geographical breakdown

DACH (Germany, Austria, Switzerland) delivered a solid H1 net fee performance, -1% YoY. Q1 saw 9% YoY growth, followed by a 9% decline in Q2. It is also worth highlighting that DACH was also impacted by strong prior year comps (H1 2019 +15% YoY). Technology in H1 was up 1%, with a strong performance in Infrastructure and Software Development.

EMEA excluding DACH, -12% YoY, reflects a more challenging performance, in particular the UK. At the same time, the Netherlands, for example, delivered a resilient performance in H1 with net fees declining only 5%. Notable performances were delivered in Life Sciences, up 10% (Q2 flat) driven by increased placements across Quality Assurance and Medical Devices, and across Engineering, where the focus is on Manufacturing, High Tech and Chemicals.

USA - The H1 performance of the US business is again very creditable in our view, net fees -1% YoY. There is resilience evident across both quarters, with strong growth across Life Sciences up 13% (Q2 up 11%) and Technology up 4% (Q2 up 5%). The region benefitted from increased activity in Quality Assurance, as more new drugs were manufactured, and seen good growth in tech skills that support digital transformation such as Mobile Applications and Software Development. This region remains a key area of focus.

APAC - net fees declined in the half year as the region was impacted by both the Australian wildfires and the earlier phasing of the Covid-19 impacts.

Taking all of the above into account it should be seen that there is a wide range of performance outcomes in H1, by region. Importantly, however, three of the top four countries for SThree overall showed only modest H1 declines YoY: Germany, -2%; Netherlands, -5%; USA, -1%. It is too early to call Q2 a bottom in terms of trading, but in our view this ‘core’ performance is very encouraging and points to a core resilience.

Group average headcount was up 2% YoY, reflecting a 5% increase in Q1. Group headcount was down 5% sequentially Q2 vs Q1. As stated, group net fees in Q2 declined 12%. However, Contract, which now accounts for 76% of Group net fees, was down ‘only’ 11%.

This more resilient performance should be expected given the nature of the model. Given SThree's much higher contract focus than quoted industry peers (who have higher permanent % exposure), we would expect the business to be less affected through the downturn. At the same time, the end of June is an important period for contract renewals.

Balance Sheet

With the duration of the COVID19 pandemic still unknown, investors are likely to remain focussed on corporate balance sheet strength. In this context, we highlight that SThree screens very well. Net cash of £31m at H1 period end (31 May 2020) compares with H1 19 net debt of £8m.

As part of the initial management response to the pandemic, SThree proactively reallocated headcount to the Glasgow-based collections team, thereby enhancing credit risk processes and systems. As a result there was a highly impressive in-quarter reduction in DSOs (Days Sales Outstanding) to 42 days, compared to 45 days in Q1. Beyond the working capital 'unwind', we assume SThree H1 cashflow has also benefited from various Government assistance initiatives and tax deferrals, though the detail behind this will be more readily apparent with the H1 results. In terms of the overall net working capital position, we would still anticipate a material position being reported at the half year (our working and unguided assumption being c.£80m).

This strong net cash position is not however the full picture in terms of overall company liquidity. In addition, the Group has a £50m revolving credit facility ("RCF"), committed out to 2023. This has now been fully drawn down. Covenants on the RCF are limited to a net debt to EBITDA ratio of 3:1 and a minimum of 4:1 on EBITDA to interest.

Separately, the Group has 'backstop' funding under the Bank of England's Covid Corporate Financing Facility ("CCFF") of £50m, and a £5m overdraft. Neither of these facilities are drawn down at present. As a further backstop, SThree also has in place a £20m accordion facility. Therefore, in total, the Group has total accessible liquidity of £136m. This is excludes the material net working capital position.

Looking further out in FY 2020, we would expect further working capital release from the Contract heavy model, to offset any earnings decline during the year, notwithstanding the timing of any recovery. Note, SThree pays its contractors before it gets paid by the companies using those contractors.

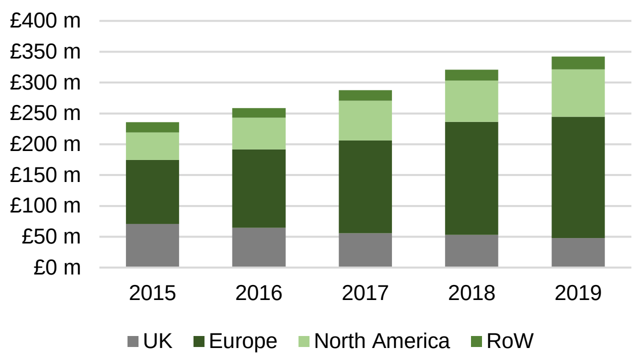
As an aside, we consider SThree's net cash balance sheet will also be noted by blue-chip industry clients looking to partner with those recruitment providers displaying strong headline balance sheets and minimal liquidity risk.

Estimates

SThree's formal market guidance remains withdrawn and we would not anticipate any change to this until at least the Q3 trading update. Although many geographies are beginning to ease their respective lockdowns; there remains a material level of uncertainty around the underlying health crisis and government responses. Hence, at this stage, we are not re-instating our own FY21 forecasts.

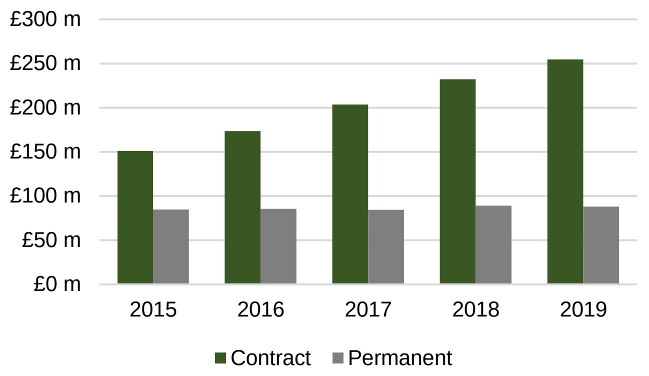
SThree - Key charts

Geographic Net Fees 5 year track record



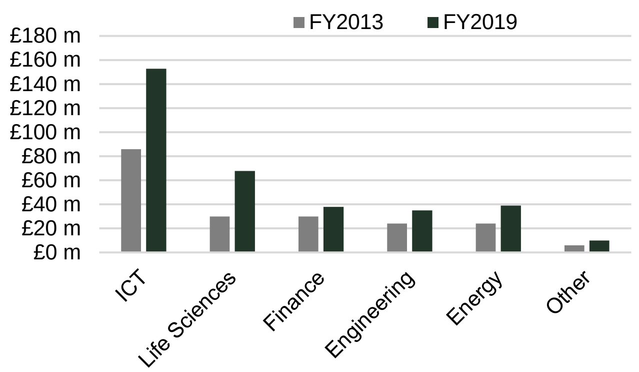
Source: FactSet, Radnor

Contract / Perm Net Fees 5 year track record



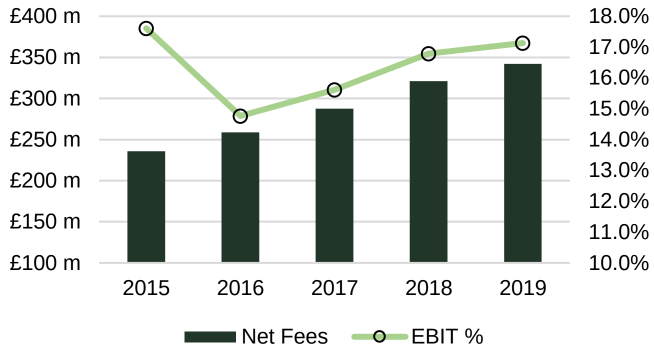
Source: FactSet, Radnor

STEM market Net Fees 2013 vs 2019



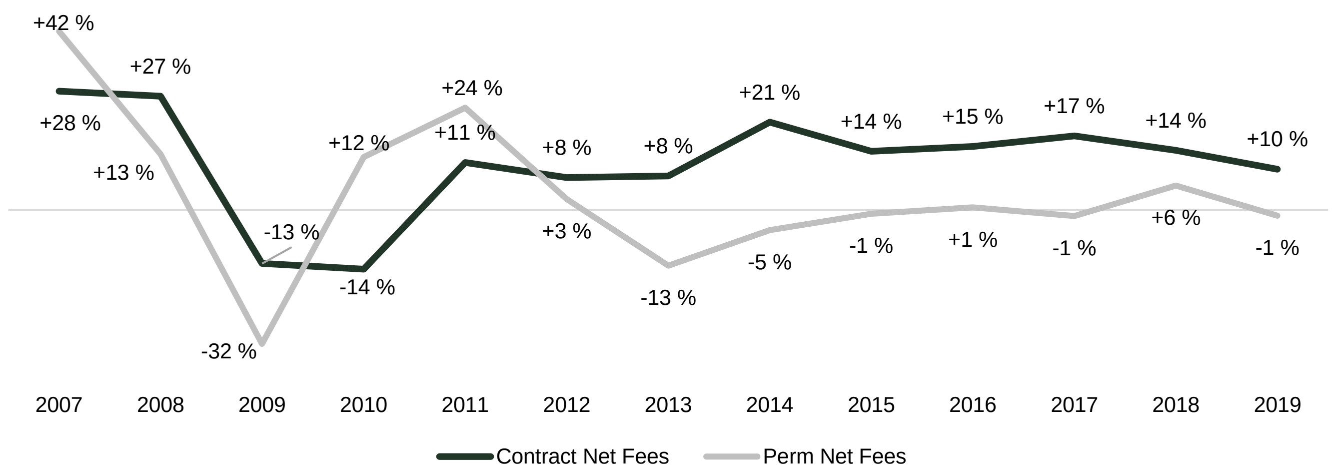
Source: FactSet, Radnor

Net Fees and EBIT margins 5 year track record



Source: FactSet, Radnor

SThree Net Fees YoY growth – Contract vs Permanent



Source: Radnor

Key Estimates

SThree PLC

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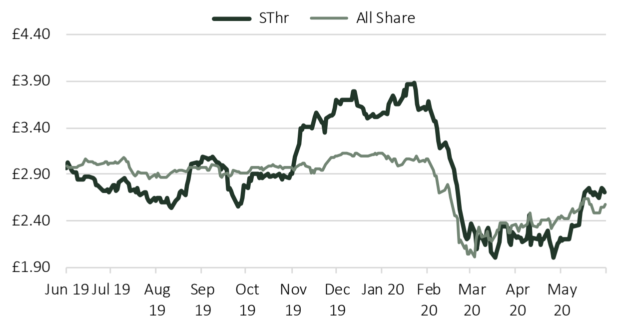
Price (p): **270 p**
Market Cap: 359 m
EV: 348 m

PROFIT & LOSS

Year to 31 November, £m	2016	2017	2018	2019E	2020E	2021E
Group Sales	**960.0**	**1,114.5**	**1,258.2**	**1,345.0**	**1,098.0**	**-**
Europe	*126.8*	*150.6*	*183.4*	*196.7*	*153.3*	-
UK	*64.7*	*55.7*	*53.1*	*48.2*	*38.6*	-
North America	*51.7*	*64.4*	*66.7*	*76.7*	*64.9*	-
Asia Pacific	*15.5*	*17.0*	*18.0*	*20.8*	*17.7*	-
Group Net Fees	**258.7**	**287.7**	**321.1**	**342.4**	**274.5**	**-**
Op. Exp.	(214.8)	(237.0)	(261.1)	(276.3)	(249.0)	-
EBITDA	**43.9**	**50.7**	**60.1**	**66.1**	**25.5**	**-**
Depr & Amort	(5.7)	(5.7)	(6.1)	(6.0)	(6.4)	-
EBITA - Adjusted	**38.2**	**44.9**	**53.9**	**60.1**	**19.1**	**-**
Associates & JV's	-	(0.1)	0.1	0.1	0.1	-
Net Bank Interest	(0.5)	(0.3)	(0.7)	(1.0)	(0.8)	-
PBT - Adjusted	**37.7**	**44.5**	**53.3**	**59.2**	**18.4**	**-**
Non Operating Items	-	(6.7)	(8.3)	-	-	-
Other Financial Items	-	-	-	-	-	-
PBT - IFRS	**37.7**	**37.8**	**45.0**	**59.2**	**18.4**	**-**
Tax - Adjusted	(9.9)	(11.4)	(13.9)	(15.9)	(5.1)	-
Tax rate - Adjusted	*26.3%*	*25.6%*	*26.0%*	*26.9%*	*27.8%*	-
Minority interests	-	-	-	-	-	-
No. shares m, diluted	132.0	132.6	133.1	133.6	133.6	-
Adj EPS (p), diluted	**21.1**	**24.9**	**29.6**	**32.3**	**10.0**	**-**
Total DPS (p)	14.0	14.0	14.5	5.1	-	-

PRICE CHART - 1 YEAR ABSOLUTE vs FTSE ALL SHARE



Source: FactSet

SHAREHOLDERS

	% of ord. Share capital
JO Hambro Cap Mgmt	10.4%
SThree Founders	5.0%
BlackRock	4.9%
Harris Assoc	4.9%
M&G	4.8%
Allianz	4.2%
Chelverton Asset Mgmt	4.0%
	38.2%

CASH FLOW

Year to 31 November, £m	2016	2017	2018	2019E	2020E	2021E
EBITDA	43.9	50.7	60.1	66.1	25.5	-
Working Capital	(4.3)	(16.4)	(25.3)	(11.7)	15.6	-
Provisions / Exceptionals	2.6	5.8	(4.7)	(1.3)	(1.5)	-
Gross Op Cashflow	**42.2**	**40.1**	**30.1**	**53.1**	**39.7**	**-**
Cash Tax	(8.5)	(10.9)	(14.4)	(13.0)	(15.9)	-
Cash Intererest	(0.5)	(0.3)	(0.5)	(1.0)	(0.8)	-
Net Op Cashflow	**33.2**	**28.9**	**15.2**	**39.1**	**23.0**	**-**
Capex	(6.1)	(5.8)	(5.2)	(4.5)	(4.5)	-
Free Cashflow	**27.1**	**23.1**	**10.0**	**34.6**	**18.5**	**-**
Dividends	(18.0)	(18.0)	(18.0)	(18.8)	(6.8)	-
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**	**11.7**	**-**
Net Cash (Debt)	**10.0**	**5.6**	**(4.1)**	**10.6**	**22.2**	**-**

Announcements

Date	Event
June 2020	H2 trading update
May 2020	CCFF access and Covid-19 update
April 2020	Covid-19 update
March 2020	Q1 trading update
Jan 2020	Final results FY19
November 2019	Capital Markets Day

RATIOS

	2017	2018	2019E	2020E	2021E
RoE	41.0%	38.8%	37.1%	11.6%	-
RoCE	59.6%	51.1%	56.7%	20.8%	-
Asset Turnover (x)	0.1x	0.1x	0.1x	0.1x	-
NWC % Revenue	16.5%	28.1%	22.8%	18.5%	-
Op Cash % EBITA	89.2%	55.8%	88.4%	207.4%	-
Net Debt / EBITDA	0.2x	0.1x	-0.1x	0.2x	-

BALANCE SHEET

Year to 31 November, £m	2016	2017	2018	2019E	2020E	2021E
Intangibles	11.6	11.4	9.6	8.0	8.0	-
P,P+E	7.1	6.7	6.9	6.8	8.7	-
Tax Asset & Other	3.2	6.0	4.7	4.2	4.2	-
Total Fixed Assets	**21.9**	**24.1**	**21.3**	**19.0**	**20.9**	**-**
Current Assets	193.9	228.1	288.4	271.0	225.7	-
Current Liabilities	(149.2)	(174.9)	(202.3)	(182.4)	(152.7)	-
Net Current Assets	**44.7**	**53.2**	**86.1**	**88.6**	**73.0**	**-**
Long Term Liabilities	(0.9)	(2.2)	(1.6)	(1.4)	(1.4)	-
Net Cash (Debt)	10.0	5.6	(4.1)	10.6	22.2	-
Net Assets	**75.7**	**80.7**	**101.6**	**116.8**	**114.7**	**-**

VALUATION

Fiscal	2017	2018	2019E	2020E	2021E
P/E	10.8x	9.1x	8.4x	27.1x	-
EV/EBITDA	6.9x	5.8x	5.3x	13.6x	-
Div Yield	5.2%	5.4%	1.9%	0.0%	-
FCF Yield	6.6%	2.9%	9.9%	5.3%	-
Net Fees growth	11.2%	11.6%	6.6%	-19.8%	-
EPS growth	18.4%	18.9%	9.1%	-69.2%	-
DPS growth	0.0%	3.6%	-64.8%	-100.0%	-

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