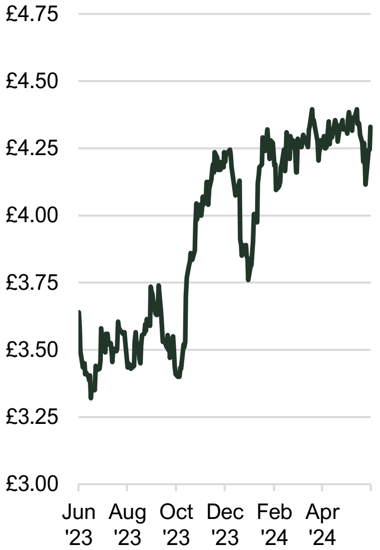
SThree PLC

STEM | FTSE 250 | Support Services | 433p | £576m

H124 update – trading in line with expectations

1 Year Chart



SThree PLC is a research client of H2 Radnor Ltd.

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

21st June 2024

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In H1 (December to May), Group net fees were down 7% (all changes at YoY constant currency change), with a 6% decline in Q1 and an 8% reduction in Q2, with the decline reflecting both a strong comparator and the ongoing challenging backdrop. Timo Lehne, CEO, said "*"Against the challenges experienced by the sector, we are pleased with our trading performance over the past six months, with strong Contract extensions partially offsetting continued soft new business activity. The Group's unique business model, centred on scarce STEM skills and flexible talent solutions, continues to be a source of strength, aligned to the strategic priorities of our clients and providing sizeable growth opportunities across all our key markets. We are well placed to take full advantage when the market returns*".

SThree said that performance for FY24 is "*currently expected to be in line with market expectations*". To be prudent, given the uncertain macro, we have nudged down our net fees forecast which leads to a PBT estimate reduction of 2%; FY24 £69.0m (previously £70.5m), FY25 £80.8m (previously £82.6m) and FY26 £88.3m (previously £90.2m).

- **Peer group trading;** we note that SThree is the first of the four largest UK companies to issue a calendar H1 statement but its comments about the market environment echo those that we heard recently from the results outlooks at Hays, Page and Robert Walters, when all three pointed to fairly sluggish market conditions in Q1.
- **The Technology Improvement Programme** (TIP) remains on track, with the phased roll-out across Germany well underway, following last year's successful launch in the USA. We are encouraged by management's comments about the TIP showing early positive results on process improvements in the USA. On German roll out, Permanent and Independent Contractor modules have been rolled out across all cities, representing c.70% of the German business, with ECM in train. The TIP roll-out started this week in UK and the Netherlands is next. We believe that the TIP has the potential to increase SThree's already sector leading conversion margin.
- **SThree's share price** has outperformed the UK Staffing peer group YTD (SThree **+2%** vs **-8%** for the peer group). We continue to see SThree trade at a material, and in our view, unjustified **41%** PE multiple discount to the peer group as the market continues to ignore the material downgrades delivered elsewhere in the peer group.

Nov, £m	Net Fees	PBT adj	EPS (p)	Div (p)	Net Cash	PE x	Yield %
FY 2022A	430.6	77.0	39.9	16.0	65.4	10.9	3.7
FY 2023A	418.8	77.9	41.5	16.6	83.2	10.2	3.8
FY 2024E	*400.0*	*69.0*	*35.9*	*14.4*	*99.5*	*12.1*	*3.3*
FY 2025E	*422.1*	*80.8*	*41.4*	*16.6*	*115.2*	*10.5*	*3.8*
FY 2026E	*445.2*	*88.3*	*44.6*	*17.9*	*124.5*	*9.7*	*4.1*

Source: h2Radnor

Main additional points of interest from the H1 update and analyst call

- **Group;** the 7% net fee reduction in H1 reflected continued softness in new business across Contract and Permanent, partially offset by strong Contract extensions, with the length of contracts in the Contractor order book having risen to 51 weeks compared with 47/48 weeks last year. H1 was a tough comp as H123 was the 2nd highest on record. H124 was the 3rd highest on record. H124 was still up 18% pre-covid.

- **Segment**; SThree continues to benefit, relatively, from its large exposure to the more defensive Contract segment. Contract (84% of net fees) declined by 6% in Q2, having reduced by 2% in Q1, whereas Permanent (16% of net fees) saw a decline of 15% in Q2 after a 21% decline in Q1. We thought it positive that the rate of decline eased, sequentially, in Permanent in Q2 as it is the more cyclical segment.

- The Contractor order book was down 2% to £182m in H1 (having declined by 1% in Q1), representing sector-leading visibility with the equivalent of c.4 months of net fees. SThree now has over 75% visibility of FY24 revenue, up from 55% at Q1, based on consensus estimates, which we believe is higher than for other recruitment companies.

- On the Employed Contractor Model (ECM), which is around 45% of Contract's net fees, there will be an investor briefing on the same day as the H1 results, on 23 July.

- **By sector**, Technology (48% of net fees) declined 9% in H1, which after a 9% reduction in Q1 implies a 9% decline in Q2. Engineering (29% of net fees) rose 8% in H1, which after a 16% increase in Q1 implies flat in Q2. Engineering continues to be driven by Energy and specifically Renewables (which increased by 15% in H1 and now represents 11% of Group net fees). Life Sciences (17% of net fees) declined 16% in H1, which after a 19% reduction in Q1 implies a 13% decline in Q2 and management said it was positive that there was a lower rate of sequential decline.

- **Of the five regions**, Netherlands (incl. Spain) (22% of Group net fees), had the best outcome with 5% growth in Q2, after growth of 8% in Q1, with Engineering in the Netherlands said to have made a strong contribution. The smaller Spanish business performed very strongly with 73% growth in H1.

- **Germany**, SThree's main country, (30% of Group net fees), saw an 11% decline in Q2, compared with a 14% reduction in Q1, mainly reflecting lower levels of demand in Technology. In Germany, the drop in contractor hours compared to pre-Covid was not that big, but has dropped to lower levels than post Covid, albeit Engineering (especially Energy) has been strong.

- **USA**, the Group's second largest country, (22% of Group net fees), saw a decline of 15% in Q2, after a 10% reduction in Q1, with declines in Life Sciences and Technology partially offset by a strong Engineering performance. The USA is the more heavily weighted region to Life Sciences. In the USA, contract is over 90% of net fees and declined by 8% in H1.

- **Rest of Europe** (17% of Group net fees), saw a 10% decline across both Q1 and Q2. The UK (11% of Group net fees) reported an 11% reduction in Q2, after a 7% decline in Q1.

- **Middle East & Asia** (5% of Group net fees), saw 1% growth in Q2, after a 20% increase in Q1. Growth continues to be led by a very strong performance from Japan (3% of Group net fees), which saw growth of 16% in Q2, after a 41% rise in Q1, with growth across all three verticals.

- **Headcount** declined by 2% at the end of H1 compared to the end of FY23. Productivity was up modestly as the decline in headcount more than offset the decline in net fees. There was a 13% YoY headcount reduction in Permanent. Period end headcount had been flat in Q1 but management said not to read anything into the 2% decline at the end of H1 as it was only 40 to 50 people and the aim is still to manage to flat headcount at year end.

- **Net cash** was £90m at the end of H1, an increase on the £72m at the end of H123, we believe due to the counter cyclical nature of working capital. For us, a building net cash position provides interesting options for acquisitions or capital returns.

Figure 1: h2Radnor estimate revisions

November year end		Previous		New		Revision	
£m	FY'23A	FY'24E	FY'25E	FY'24E	FY'25E	FY'24E	FY'25E
Gross Revenue	1,663.2	1,628.6	1,716.2	1,590.8	1,676.3	(2%)	(2%)
Net fees							
DACH	148.9	136.7	144.0	134.2	141.3	(2%)	(2%)
Netherlands inc. Spain	82.1	84.9	89.9	85.7	90.8	1%	1%
Rest of Europe	70.4	70.4	72.9	66.9	69.3	(5%)	(5%)
USA	96.4	94.3	101.0	90.6	97.1	(4%)	(4%)
Middle East, Asia	20.9	22.6	23.7	22.6	23.7	0%	0%
Total Net Fees	**418.8**	**408.9**	**431.6**	**400.0**	**422.1**	**(2%)**	**(2%)**
EBITA	76.4	69.5	81.6	68.0	79.8	(2%)	(2%)
Margin (%)	*18.2%*	17.0%	18.9%	17.0%	18.9%		
Adj. PBT	**77.9**	**70.5**	**82.6**	**69.0**	**80.8**	**(2%)**	**(2%)**
Adj. EPS (p)	41.5	36.7	42.3	35.9	41.4	(2%)	(2%)
DPS (p)	16.6	14.7	16.9	14.4	16.6	(2%)	(2%)
Net cash (debt)	83.2	100.1	116.2	99.5	115.2	(1%)	(1%)

Source: h2Radnor

SThree's continuing relative outperformance not reflected in valuation

In what are undoubtedly tricky trading conditions, the dual aspect of SThree's business model continues to stand out relative to UK listed peers. SThree's net fee generation is a function of two elements:

→ **Contract extensions and renewals** have proven resilient with performance here at least in-line, if not marginally better than initial expectations. We note the material increase in average Contract lengths and also continuing wage inflation, which all point to a positive demand / supply imbalance. SThree has also seen overall pricing holding up well, further supports this underlying demand dynamic.

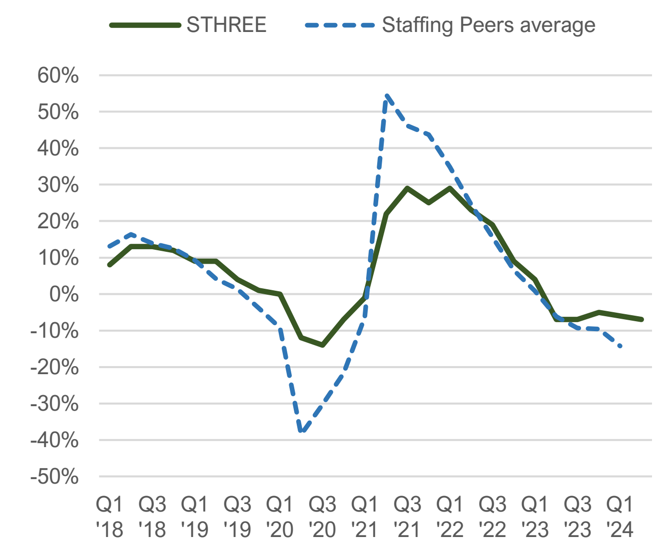
→ **New business** has been softer, a point that the company has been explicit around throughout FY23. Lead macro indicators, despite improving sentiment, are yet to show any meaningful improvement.

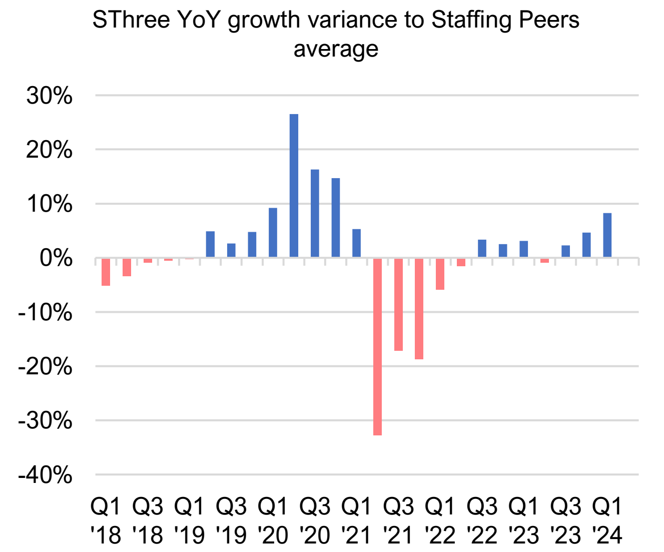
We have highlighted in previous research notes that this interplay between the existing Contractor base and the new business pipeline is a feature of SThree that marks it out from UK listed peers; none of whom enjoy the same weighting towards Contract and the net fee duration and visibility that the SThree flavour of Contract enjoys.

The key point here is not that SThree is immune from cyclical pressures that affect all recruitment businesses; but that the SThree net fee and margin curves should be flatter and significantly less volatile than others. The extent of estimate downgrades across the peer group bear this out.

In Figure 2 & 3 below we show the extent to which SThree's quarterly net fee YoY growth has varied from the UK staffing peer group average. This shows SThree's material outperformance through the pandemic and more recently since Q3 2022. We can see a similar shape take form when we look at how one year forecast estimates have evolved across the peer group over the course of the last year (Fig 4 and 5).

Figure 2 & 3: SThree Quarterly YoY Net Fee Growth relative to UK Staffing Peer Group average





Source: Radnor

Below in Figure 4 we show the evolution of consensus FY1 PBT estimates for SThree and the peer group, rebased to SThree, over the last year. In Figure 5 we show the evolution of consensus FY1 EBIT margins for each member of the peer group.

Figure 4: SThree vs Peers – Consensus PBT

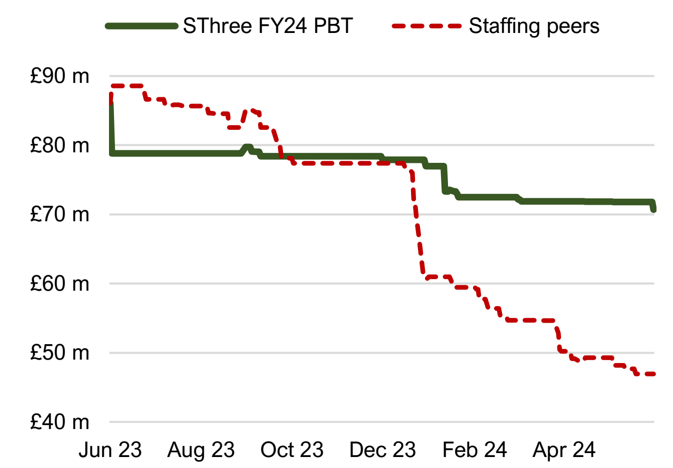
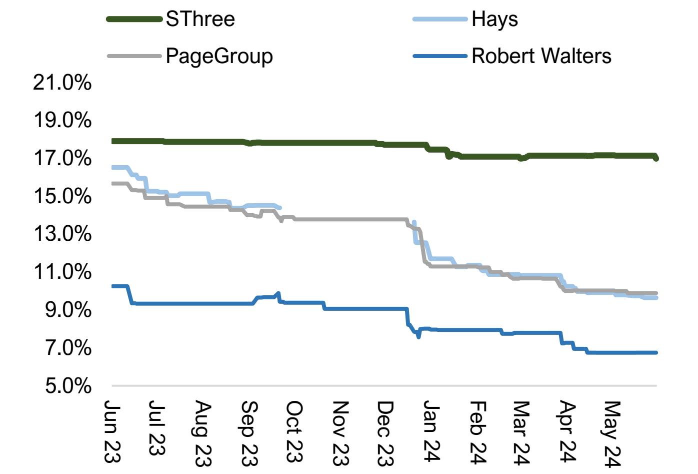


Figure 5: SThree vs Peers – Margin expectations



Source: h2Radnor, FactSet

- Over the last six months, the peer group has seen FY24 PBT consensus expectations downgraded in aggregate by **-39%**. By contrast, SThree has seen FY24 PBT consensus decline by **-10%.**

- SThree's margin expectations are taken **after** the TIP P&L cost, which has been guided between £6m - £8m in FY24E. On an underlying basis, we estimate FY24 EBIT margins would be c**18.7%** versus our current expectation of 17.0%, which is still some distance ahead of the peer group**.**

Despite this clear net fee and margin outperformance, the valuation gap between SThree and its peers remains material and has widened back out in recent months as extensive peer group downgrades have not fed through into share price performance. In Figure 6 & 7 below, we show the evolution of the one-year prospective PE multiple for both SThree and the UK listed staffing Peer group (Hays, Page, Robert Walters).

Figure 6: 1 Year prospective PE multiple

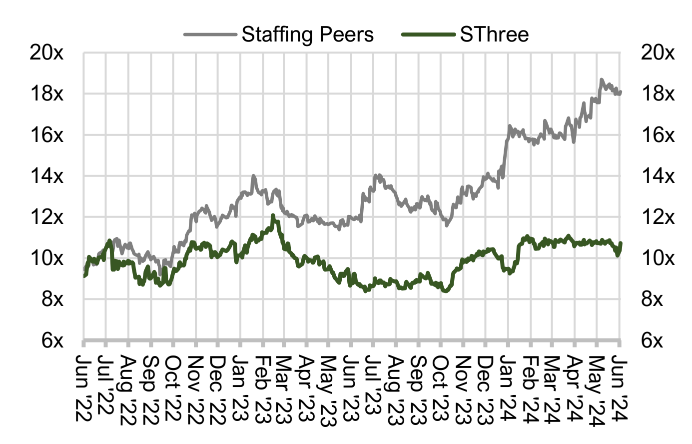
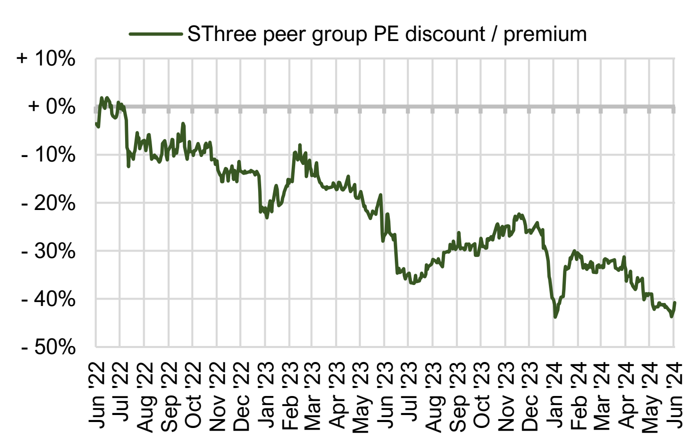


Figure 7: SThree PE discount / premium



Source: h2Radnor, FactSet

SThree PLC

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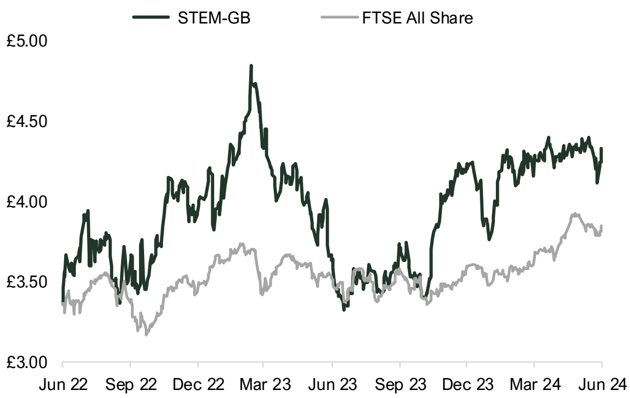
Price (p): **433 p**
Market Cap: 576 m
EV: 493 m

PROFIT & LOSS

Year to 31 November, £m	2022	2023	2024E	2025E	2026E
Group Sales	**1,639.4**	**1,663.2**	**1,590.8**	**1,676.3**	**1,765.5**
DACH	*148.9*	*148.9*	*134.2*	*141.3*	*148.7*
Netherlands	*75.7*	*82.1*	*85.7*	*90.8*	*96.2*
Rest of Europe	*73.1*	*70.4*	*66.9*	*69.3*	*71.8*
USA	*111.5*	*96.4*	*90.6*	*97.1*	*103.7*
ME & Asia	*21.4*	*20.9*	*22.6*	*23.7*	*24.9*
Group Net Fees	**430.6**	**418.8**	**400.0**	**422.1**	**445.2**
Op. Exp.	(334.2)	(326.5)	(316.8)	(326.3)	(341.4)
EBITDA	**96.5**	**92.3**	**83.2**	**95.8**	**103.7**
Depr & Amort (incl lease)	(18.9)	(15.9)	(15.2)	(16.0)	(16.9)
EBITA - Adjusted	**77.6**	**76.4**	**68.0**	**79.8**	**86.8**
EBITA conversion %	**18.0%**	**18.2%**	**17.0%**	**18.9%**	**19.5%**
Associates & JV's	-	-	-	-	-
Net Bank Interest	(0.5)	1.6	1.0	1.0	1.5
PBT - Adjusted	**77.0**	**77.9**	**69.0**	**80.8**	**88.3**
Non Operating Items	-	-	-	-	-
Other Financial Items	-	-	-	-	-
PBT - IFRS	**77.0**	**77.9**	**69.0**	**80.8**	**88.3**
Tax - Adjusted	(22.8)	(21.9)	(20.0)	(23.8)	(26.5)
Tax rate - Adjusted	*29.6%*	*28.1%*	*29.0%*	*29.5%*	*30.0%*
Minority interests	-	-	-	-	-
No. shares m, diluted	135.9	135.0	136.5	137.5	138.5
Adj EPS (p), diluted	**39.9**	**41.5**	**35.9**	**41.4**	**44.6**
Total DPS (p)	16.0	16.6	14.4	16.6	17.9

PRICE CHART - 2 YEAR ABSOLUTE vs FTSE ALL SHARE



Source: FactSet

SHAREHOLDERS

	% of ord. Share capital
Kempen Cap Mgmt	11.6%
JPMorgan AM	6.4%
JO Hambro	5.7%
Littlejohn	5.1%
Allianz	4.9%
BlackRock	4.8%
Montanaro	3.7%
	42.2%

CASH FLOW

Year to 31 November, £m	2022	2023	2024E	2025E	2026E
EBITDA	96.5	92.3	83.2	95.8	103.7
Working Capital	(38.6)	(4.0)	(0.4)	(13.5)	(23.6)
Exceptionals / Other	6.5	5.0	(0.6)	(0.6)	(0.1)
Gross Op Cashflow	**64.4**	**93.3**	**82.2**	**81.8**	**80.1**
Cash Tax	(18.9)	(19.5)	(18.0)	(21.4)	(23.8)
Cash Intererest	(0.7)	(0.7)	1.0	1.0	1.5
Net Op Cashflow	**44.8**	**73.1**	**65.2**	**61.3**	**57.7**
Capex	(3.7)	(8.2)	(5.6)	(2.5)	(1.8)
Lease	(13.7)	(14.3)	(12.8)	(13.5)	(14.2)
Free Cashflow	**27.4**	**50.6**	**46.8**	**45.3**	**41.7**
Dividends	(14.7)	(27.4)	(22.2)	(20.7)	(23.4)
Acquisitions & Inv.	-	-	-	-	-
Lease / EBT	(9.4)	(7.6)	(8.4)	(8.9)	(8.9)
Net Cashflow	**3.4**	**15.7**	**16.3**	**15.7**	**9.3**
Net Cash (Debt)	**65.4**	**83.2**	**99.5**	**115.2**	**124.5**

Announcements

Date	Event
18 June 2024	H1 update
19 March 2024	Q1 update
30 January 2024	FY results
14 December 2023	Q4 update
19 September 2023	Q3 update
25 July 2023	H1 results

RATIOS

	2022	2023	2024E	2025E	2026E
RoE	27.0%	25.1%	20.2%	21.0%	20.4%
RoCE	57.4%	54.7%	47.5%	51.0%	48.5%
Asset Turnover (x)	0.1x	0.1x	0.1x	0.1x	0.1x
NWC % Revenue	37.1%	34.6%	38.7%	40.0%	41.9%
Op Cash % EBITA	83.0%	122.2%	120.9%	102.5%	92.2%
Net Debt / EBITDA	-0.7x	-0.9x	-1.2x	-1.2x	-1.2x

BALANCE SHEET

Year to 31 November, £m	2022	2023	2024E	2025E	2026E
Intangibles	0.8	7.1	0.8	0.8	0.8
P,P+E	35.2	31.1	34.5	34.7	34.0
Tax Asset & Other	4.6	5.8	5.8	5.8	5.8
Total Fixed Assets	**40.7**	**44.0**	**47.0**	**46.7**	**45.6**
Current Assets	363.9	345.1	365.5	400.1	446.0
Current Liabilities	243.6	229.5	249.5	270.7	292.9
Net Current Assets	**120.3**	**115.6**	**116.0**	**129.5**	**153.1**
Long Term Liabilities	14.8	24.1	27.1	26.9	25.7
Net Cash (Debt)	65.4	83.2	99.5	115.2	124.5
Net Assets	**200.4**	**222.9**	**242.5**	**271.5**	**303.3**

VALUATION

Fiscal	2022	2023	2024E	2025E	2026E
P/E	10.9x	10.4x	12.1x	10.5x	9.7x
EV/EBITDA	5.1x	5.3x	5.9x	5.1x	4.8x
Div Yield	3.7%	3.8%	3.3%	3.8%	4.1%
FCF Yield	5.6%	10.3%	9.5%	9.2%	8.5%

YoY growth					
Net Fees	21.1%	-2.7%	-4.5%	5.5%	5.5%
EPS	29.9%	4.1%	-13.6%	15.4%	7.8%
DPS	45.5%	3.8%	-13.5%	15.4%	7.8%

REGULATORY DISCLOSURES

H2 Radnor Ltd is authorised and regulated by the Financial Conduct Authority.

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