SThree PLC

STEM | FTSE 250 | Support Services | 412p | £546m

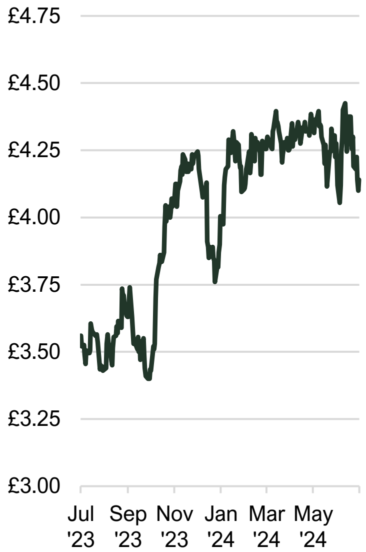
H124 results and ECM webinar feedback

SThree's H1 results underscored how it continues to outperform the other three quoted UK recruitment companies, which mainly reflects its more defensive profile with Contract comprising 84% of net fees (up from 74% in FY19), which saw net fees decline by 4%, compared to Permanent, accounting for only 16% of net fees, which reported an 18% decline in net fees. In contrast, the other three quoted UK recruitment companies have, on average, a 40/60% net fee exposure to Contract vs Permanent.

We maintain our FY24 forecast of £69.0m but reduced our FY25 PBT estimate by 14%, reflecting a lower assumption for net fees and operating profit conversion ratio (OPCR). In FY26, we lower our PBT estimate by 4%, due to the knock-on effect of lower FY25 net fees, albeit we have maintained our assumption for net fee growth and the conversion margin in FY26.

- **ECM:** In the afternoon, SThree held a separate webinar on its Employed Contractor Model (ECM). ECM has outgrown both the company's other segments; Independent Contractor and Permanent and the webinar was useful for setting out the complexity of managing ECM, which gives SThree a significant competitive advantage.
- **Peer group trading:** we note that SThree continues to perform much better in terms of net fees than Hays, Page and Robert Walters. YTD, the Staffing peer group has averaged **-13.6%** YoY net fee declines, with SThree averaging -6.5%, less than half the peer group decline. In keeping with this operational outperformance, SThree's share price has outperformed the UK Staffing peer group YTD (SThree **-1.8%** vs **-13.7%** for the peer group).
- **Relative Valuation**: Despite both SThree's continuing net fee and margin outperformance relative to the UK peer group and the share price outperformance, we continue to see a material valuation disconnect between the two. SThree currently trades on a 50% plus PE discount (the highest discount level for two years) to its more cyclically exposed peers as extensive peer group downgrades (far exceeding SThree) have not been reflected in their share price performance. Given SThree's clear ability to better maintain margins and superior net fee resilience, this discount is not warranted.

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.

1 August 2024

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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	10.3	3.9
FY 2023A	418.8	77.9	41.5	16.6	83.2	9.9	4.0
FY 2024E	*400.0*	*69.0*	*35.9*	*14.4*	*101.4*	*11.5*	*3.5*
FY 2025E	*400.0*	*69.3*	*35.5*	*14.2*	*114.4*	*11.6*	*3.4*
FY 2026E	*421.8*	*85.1*	*43.0*	*17.2*	*128.2*	*9.6*	*4.2*

Source: h2Radnor

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

- **Net fees** (constant currency) declined by 7%, from £208.6m in H123 to £188.7m in H124, the same figure mentioned in the H1 update on 18 June. H1 was a tough comp as H123 was the highest on record. H124 was the 3rd highest on record. H124 was still up 18% pre-covid. The 7% net fee reduction in H1 reflected continued softness in new business across Contract and Permanent, partially offset by strong Contract extensions. In Permanent, SThree reported an 18% decline in net fees, reflecting market conditions and a 13% reduction in average permanent headcount. In Permanent, the Netherlands and Japan are improving but the US and Germany are still weak.

- We believe that the Group's outperformance versus peers, against a tough macro backdrop, mainly reflects its more defensive profile with Contract comprising 84% of net fees (up from 74% in FY19), which saw net fees decline by 4%, compared to Permanent, accounting for only 16% of net fees, which reported an 18% decline in net fees. In contrast, the other three quoted UK recruitment companies have, on average, a 40/60% net fee exposure to Contract vs Permanent.

- The presentation showed that indexed to FY19, SThree's net fees are at 116% compared with 95% for the other three listed companies. Plus, we think that the Group benefits structurally from the growing proportion of roles which require STEM skills and the statement mentioned that "contract extensions continue to be robust as clients seek to retain much-needed STEM expertise".

- The contractor order book of £182.1m, whilst down 2% YoY (constant currency), versus a very strong comparator, represents sector-leading visibility with the equivalent of around four months' net fees, partially offsetting the soft new business environment, and providing a robust platform for the year ahead. The average contract length rose by 9% YoY to 51 weeks, pricing held up with the contract margin flat YoY at 21.7% and the average contract salary rose by 4% to £102k.

- **Current trading**; the statement said that "contract extensions remain strong whilst new business activity continues to be subdued" and added that "whilst market conditions have remained challenging for longer than anticipated, performance for FY24 PBT currently expected to be in line with market expectations", which the company said was £69.2m for FY24. SThree does not yet report on June, but as recently reported by competitors, during Q&A June was said to be weaker than Q2, albeit it was said to be better than that reported by competitors.

- Given the subdued new business activity we have maintained our assumption of a 4% reduction in net fees in FY24 but switch from an expectation of 5% growth in FY25 to flat, although we retain our assumption of 5% growth in FY26.

- **Operating profit** increased by 3% (constant currency), from £38.1m in H123 to £37.7m in H123, with the OPCR rising from 18.3% in H123 to 20.0% in H124. Excluding the Opex of the TIP, the OPCR rose from 19.5% in H123 to 20.5% in H124. The rise in the OPCR was due to three main factors; a headcount reduction of 10%, lower TIP costs, £5m from careful cost management. Management said that the last point was the main difference compared to expectations at the FY, albeit costs will increase in H2, for example headcount is expected to end the year flat.

- The statement added that “we expect the conversion ratio to temper in the second half of the year due to additional licensing and amortisation costs as we roll out the Technology Improvement Programme alongside planned investments to ensure the Group is well positioned for when market conditions improve”.

- In FY24 we have maintained our PBT estimate of £69.0m reducing our OPCR from 17.0% to 16.7% but increasing the interest income. In FY25, we reduce our PBT estimate by 14%, mainly as we expect the more subdued net fee backdrop to make it difficult to increase the OPCR, which we forecast at 16.7% rather than the 18.9% previously, so stable on FY24. In FY26, we reduce our PBT estimate by 4%, due to the impact of the reduced net fee estimate in FY25, but we maintain our OPCR forecast of 19.5% as the benefits from the TIP materialise. We set out our estimate changes below.

Figure 1: h2Radnor estimate changes

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	1,590.8	1,676.3	1,590.8	1,588.3	0%	(5%)
Net fees							
DACH	148.9	134.2	141.3	134.2	133.5	0%	(5%)
Netherlands (incl. Spain)	82.1	85.7	90.8	85.7	85.9	0%	(5%)
Rest of Europe	70.4	66.9	69.3	66.9	65.8	0%	(5%)
USA	96.4	90.6	97.1	90.6	92.1	0%	(5%)
Middle East & Asia	20.9	22.6	23.7	22.6	22.7	0%	(4%)
Total Net Fees	**418.8**	**400.0**	**422.1**	**400.0**	**400.0**	**0%**	**(5%)**
EBITA	76.4	68.0	79.8	66.8	66.8	(2%)	(16%)
Margin (%)	*18.2%*	*17.0%*	*18.9%*	*16.7%*	*16.7%*		
Adj. PBT	**77.9**	**69.0**	**80.8**	**69.0**	**69.3**	**0%**	**(14%)**
Adj. EPS (p)	41.5	35.9	41.4	35.9	35.5	0%	(14%)
DPS (p)	16.6	14.4	16.6	14.4	14.2	0%	(14%)
Net cash (debt)	83.2	99.5	115.2	101.4	114.4	2%	(1%)

Source: h2Radnor

- **The TIP** remains on track and budget, it has been rolled-out in the US, the roll-out in Germany is well underway and the roll-out has been completed in the UK and the Netherlands will be next. The recent roll-out in London was described as the smoothest to date. The statement said that “with each regional roll-out, we are absorbing new learnings and becoming increasingly efficient in our deployments”. Cost optimisations are already coming through in the US, which is the first country in which TIP was rolled-out. We believe that the TIP has the potential to materially increase SThree’s OPCR.

- **Net cash** was £90m at the end of H1, an increase on the £72m at the end of H123 and the £83m at the end of FY23. During Q&A management said that of the £90m of cash, £40m is needed for monthly working capital swings and a further £15m to £20m for when growth returns, but that does leave some spare. Uses of surplus cash are prioritised on the dividend (which rose by 2% in H1), investments in organic growth and the TIP programme. M&A is more likely when the TIP is up and running, no news yet but M&A is on the horizon. Thereafter buybacks or special dividends would be considered but there are no plans for these yet.

ECM webinar

- In the afternoon of the results day, SThree held a webinar on ECM. Since H119, ECM has risen from 22% of net fees to 38%, whereas Permanent reduced from 26% of net fees to 16% and Independent Contractor from 52% of net fees to 46%. The ECM and Independent Contractor segments have grown faster than Permanent, partly as both clients and employees in recent years have favoured flexible working. ECM is the predominant model in the US and is becoming increasingly important elsewhere due to increasingly complex rules around the employment of contractors as governments seek to increase tax revenues and pension contributions.

- Under ECM, contractors are directly employed by SThree who as a result deals with their holidays, taxes, pension, insurance and illness cover. SThree potentially carries bench-risk if ECM contractors are not deployed to clients, but management said this risk is low and that less than 1% of contractors at a time are not deployed.

- Operating ECM is complex due four main factors, which SThree needs to; 1) understand the regulatory landscape in each country around the rules for using contractors 2) ensure that its ECM contractors are employed under compliant employment models, with licences or appropriate infrastructure 3) manage the employment of contractors e.g. health & safety, discrimination laws and working time directives 4) be able to fund the working capital requirement of ECM.

- Clients are willing to pay a premium for SThree to take away the management of contractors with net fee margins for ECM typically 30 to 40% higher than for independent contractors. Even with the extra costs associated with managing ECM (e.g. legal professionals, placement support, credit controllers and HR professionals), ECM is higher margin than Independent Contractors and Permanent and its relative growth is one of the reasons why SThree is confident of reaching a 21% OPCR over time.

- SThree has a competitive advantage as it is the only global, scale operator of ECM, especially with STEM. Smaller competitors lack the resource that setting up ECM requires and larger competitors are often burdened with outdated methods of operating contractor models.

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.

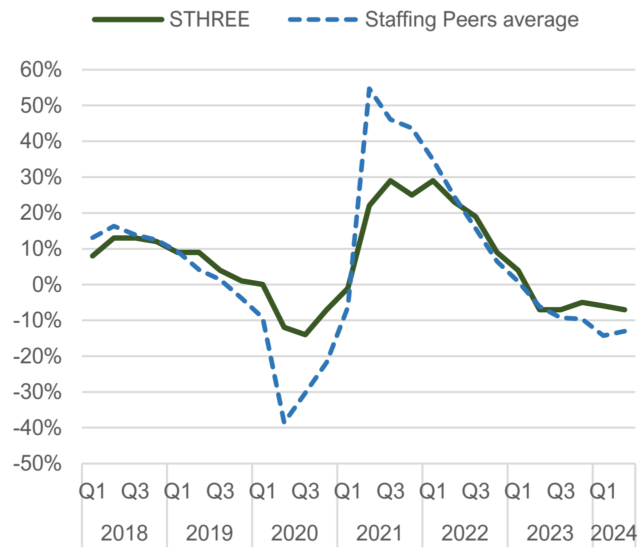
→ **New business** has been softer, a point that the company has been explicit around throughout FY23. Lead macro indicators, despite improving sentiment, are yet to show any meaningful improvement.

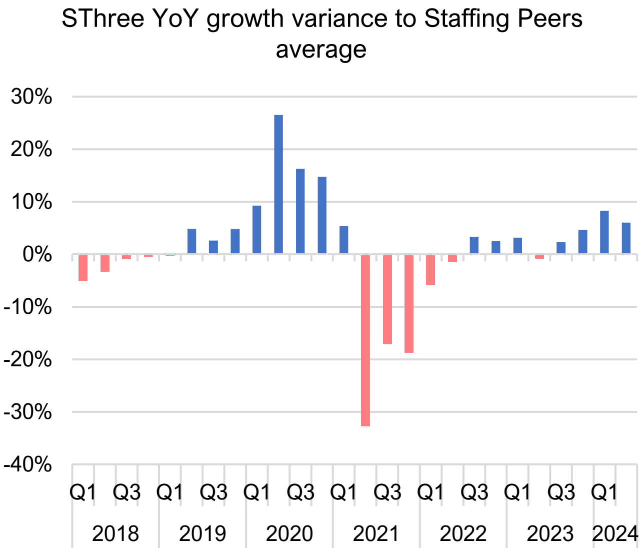
We have highlighted in previous research notes that this interplay between the existing Contractor base and the new business pipeline is a feature of SThree that marks it out from UK listed peers; none of whom enjoy the same weighting towards Contract and the net fee duration and visibility that the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

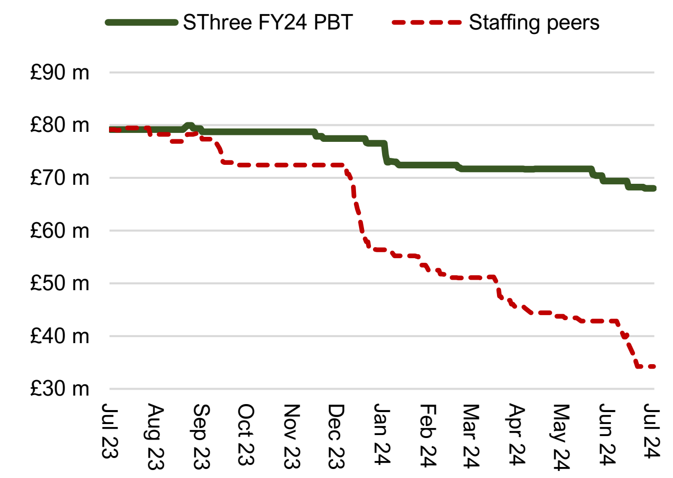
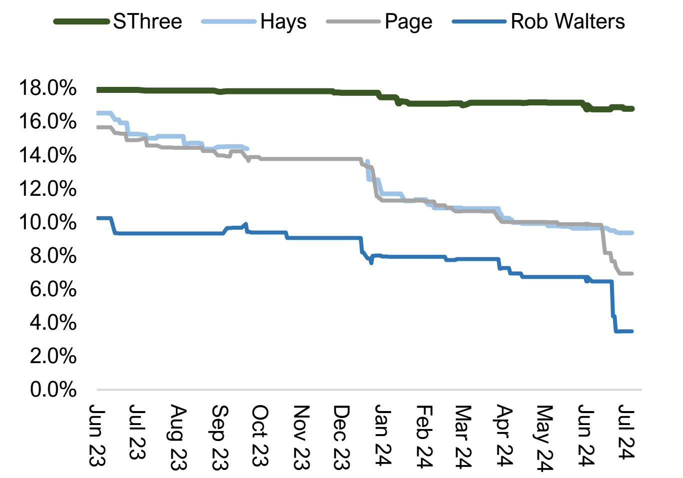


Figure 5: SThree vs Peers – Margin expectations



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 **-9%.**

- 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 headline **17.0%**, which is materially ahead of the peer group average of **6.6%**

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

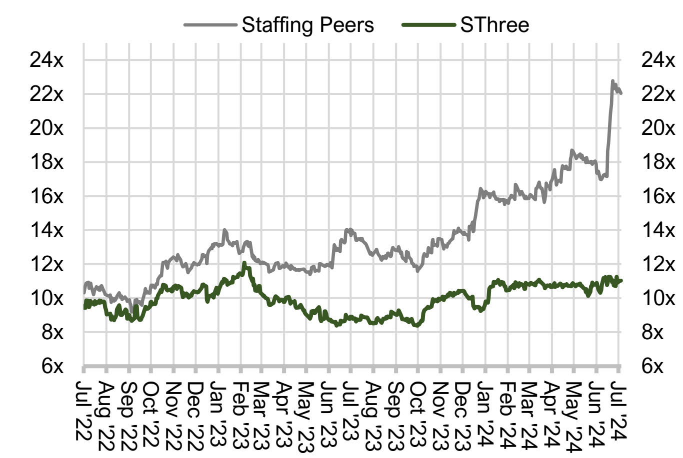
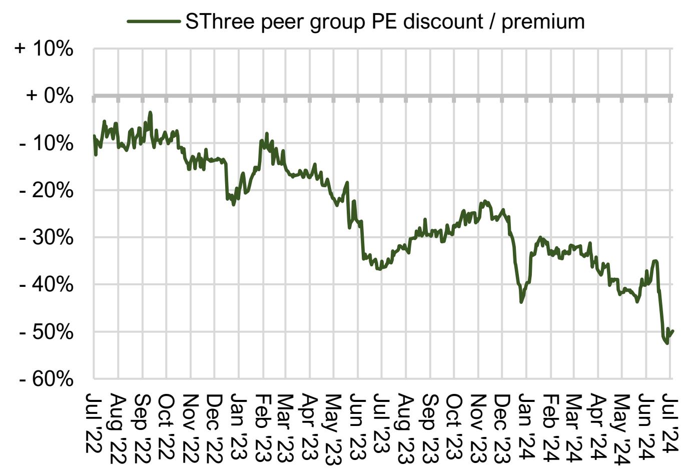


Figure 7: SThree PE discount / premium



Source: h2Radnor, FactSet

SThree PLC

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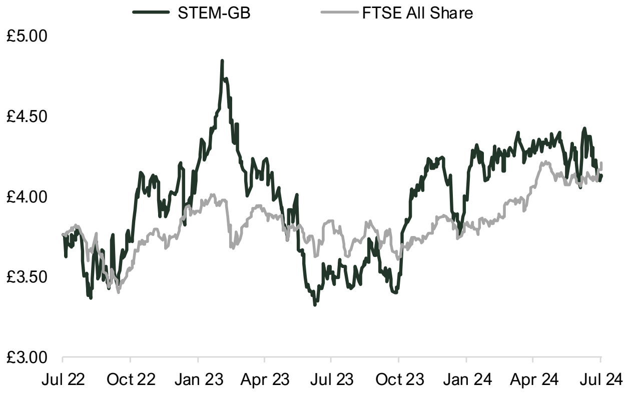
Price (p): **412 p**
Market Cap: 546 m
EV: 462 m

PROFIT & LOSS					
Year to 31 November, £m	**2022**	**2023**	**2024E**	**2025E**	**2026E**
Group Sales	**1,639.4**	**1,663.2**	**1,590.8**	**1,588.3**	**1,672.7**
DACH	*148.9*	*148.9*	*134.2*	*133.5*	*140.6*
Netherlands	*75.7*	*82.1*	*85.7*	*85.9*	*91.0*
Rest of Europe	*73.1*	*70.4*	*66.9*	*65.8*	*68.1*
USA	*111.5*	*96.4*	*90.6*	*92.1*	*98.3*
ME & Asia	*21.4*	*20.9*	*22.6*	*22.7*	*23.9*
Group Net Fees	**430.6**	**418.8**	**400.0**	**400.0**	**421.8**
Op. Exp.	(334.2)	(326.5)	(318.0)	(318.0)	(323.5)
EBITDA	**96.5**	**92.3**	**82.0**	**82.0**	**98.3**
Depr & Amort (incl lease)	(18.9)	(15.9)	(15.2)	(15.2)	(16.0)
EBITA - Adjusted	**77.6**	**76.4**	**66.8**	**66.8**	**82.3**
EBITA conversion %	**18.0%**	**18.2%**	**16.7%**	**16.7%**	**19.5%**
Associates & JV's	-	-	-	-	-
Net Bank Interest	(0.5)	1.6	2.2	2.5	2.8
PBT - Adjusted	**77.0**	**77.9**	**69.0**	**69.3**	**85.1**
Non Operating Items	-	-	-	-	-
Other Financial Items	-	-	-	-	-
PBT - IFRS	**77.0**	**77.9**	**69.0**	**69.3**	**85.1**
Tax - Adjusted	(22.8)	(21.9)	(20.0)	(20.4)	(25.5)
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**	**35.5**	**43.0**
Total DPS (p)	16.0	16.6	14.4	14.2	17.2

PRICE CHART - 2 YEAR ABSOLUTE vs FTSE ALL SHARE



Source: FactSet

SHAREHOLDERS	% of ord. Share capital
Kempen Cap Mgmt	11.8%
JPMorgan AM	6.1%
JO Hambro	5.8%
BlackRock	5.3%
Allianz	4.8%
Montanaro	3.6%
Harris Associates	3.6%
	41.0%

CASH FLOW					
Year to 31 November, £m	**2022**	**2023**	**2024E**	**2025E**	**2026E**
EBITDA	96.5	92.3	82.0	82.0	98.3
Working Capital	(38.6)	(4.0)	(0.4)	(12.8)	(22.4)
Exceptionals / Other	6.5	5.0	0.6	0.9	1.2
Gross Op Cashflow	**64.4**	**93.3**	**82.2**	**70.1**	**77.2**
Cash Tax	(18.9)	(19.5)	(18.0)	(18.4)	(23.0)
Cash Intereest	(0.7)	(0.7)	2.2	2.5	2.8
Net Op Cashflow	**44.8**	**73.1**	**66.4**	**54.2**	**57.0**
Capex	(3.7)	(8.2)	(5.6)	(2.4)	(1.7)
Lease	(13.7)	(14.3)	(12.8)	(12.8)	(13.5)
Free Cashflow	**27.4**	**50.6**	**48.0**	**39.0**	**41.8**
Dividends	(14.7)	(27.4)	(22.6)	(19.1)	(21.0)
Acquisitions & Inv.	-	-	-	-	-
Lease / EBT	(9.4)	(7.6)	(7.2)	(6.9)	(7.1)
Net Cashflow	**3.4**	**15.7**	**18.2**	**13.0**	**13.8**
Net Cash (Debt)	**65.4**	**83.2**	**101.4**	**114.4**	**128.2**

Announcements	
Date	**Event**
23 July 2024	H1 results & ECM investor briefing
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

RATIOS	2022	2023	2024E	2025E	2026E
RoE	27.0%	25.1%	20.0%	18.1%	19.5%
RoCE	57.4%	54.7%	46.7%	42.9%	46.5%
Asset Turnover (x)	0.1x	0.1x	0.1x	0.1x	0.1x
NWC % Revenue	37.1%	34.6%	38.7%	42.0%	43.8%
Op Cash % EBITA	83.0%	122.2%	123.1%	105.0%	93.8%
Net Debt / EBITDA	-0.7x	-0.9x	-1.2x	-1.4x	-1.3x

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**	**45.7**
Current Assets	363.9	345.1	365.5	398.3	441.8
Current Liabilities	243.6	229.5	249.5	269.5	290.6
Net Current Assets	**120.3**	**115.6**	**116.0**	**128.8**	**151.1**
Long Term Liabilities	14.8	24.1	27.1	26.9	25.8
Net Cash (Debt)	65.4	83.2	101.4	114.4	128.2
Net Assets	**200.4**	**222.9**	**244.5**	**270.1**	**305.1**

VALUATION					
Fiscal	**2022**	**2023**	**2024E**	**2025E**	**2026E**
P/E	10.3x	9.9x	11.5x	11.6x	9.6x
EV/EBITDA	4.8x	5.0x	5.6x	5.6x	4.7x
Div Yield	3.9%	4.0%	3.5%	3.4%	4.2%
FCF Yield	5.9%	10.9%	10.4%	8.4%	9.0%
YoY growth					
Net Fees	21.1%	-2.7%	-4.5%	0.0%	5.5%
EPS	29.9%	4.1%	-13.6%	-1.0%	21.0%
DPS	45.5%	3.8%	-13.5%	-1.0%	21.0%

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