SThree PLC

STEM | Small Cap | Support Services | 359p | £478m

Q1’21 Trading Update – 11% PBT upgrade

SThree’s trading commentary through the second half of FY’20 had already highlighted the resilience of the business model. Yesterday’s trading update served to highlight how well positioned SThree is to exit the pandemic in good shape. Two key markets; DACH and the USA (together 60% of group net fees) have delivered positive YoY growth; ahead of expectations. Whilst +19% YoY growth in the US will capture the headlines, +3% growth in DACH is arguably more impressive given the strength of the Q1’20 comparative (+9%). All in all, SThree was able to deliver a flat YoY performance against a comparatively largely undisturbed by the pandemic; laying a solid foundation for the year to come (potential FX headwinds notwithstanding).

Historically, SThree’s quarterly updates focus on net fees. However, it is clear that net fee stabilisation, coupled with the return to growth of the contractor order book and the full effects of 2020 cost actions will feed into stronger margins. We upgrade our FY’21 PBT by 11% and see further tailwinds behind margins if current trends are maintained. Despite recent strength, the shares continue to trade at a material discount to the UK staffing peer group despite the clear blue water between SThree and the rest. In our eyes, the market is pricing in a degree of cyclical snap back for the peers that has yet to materialize.

- **Q1 highlights:** Overall net fees were flat (adjusted for working days) against a comparative largely undisturbed by Covid-19. Germany has returned to growth and the US continues to grow at an impressive rate. Volatility remains elsewhere but the broad picture of sequential improvements remains uniform.

- **Productivity gains continue:** The final results highlighted a strong Q4 for productivity and this has continued into Q1. FY’20 cost savings have played the part but the return to growth of the Contractor order book and good new deal momentum means that margins are being driven above and below the line.

- **Clear blue water:** Although we have yet to hear from the others in the peer group; it has been clear since H1 of last year that SThree has shown far greater resilience. This should come as no surprise given SThree’s contract and niche STEM focus. The more interesting question is around the growth profile from here and how that compares.

- **Valuation discount persists:** Unsurprisingly, SThree has outperformed the peer group YTD (shares are up +17% vs +11%), however the PE discount persists. We find this hard to justify given the extent of the operational outperformance and the positive earnings estimate revision trend SThree has enjoyed. We sense a market looking for a cyclical snap back to favour the peer group but we have yet to see the evidence for this come through.

<table>
<thead>
<tr>
<th>November, £m</th>
<th>Net Fees</th>
<th>PBT adj</th>
<th>EPS (p)</th>
<th>Div (p)</th>
<th>Net Cash</th>
<th>Fiscal PER x</th>
<th>Yield %</th>
</tr>
</thead>
<tbody>
<tr>
<td>FY 2018A</td>
<td>321.1</td>
<td>53.3</td>
<td>29.6</td>
<td>14.5</td>
<td>-4.1</td>
<td>12.1</td>
<td>4.0</td>
</tr>
<tr>
<td>FY 2019A</td>
<td>338.0</td>
<td>59.1</td>
<td>32.3</td>
<td>5.1</td>
<td>10.6</td>
<td>11.1</td>
<td>1.4</td>
</tr>
<tr>
<td>FY 2020A</td>
<td>308.6</td>
<td>30.1</td>
<td>13.5</td>
<td>5.0</td>
<td>49.9</td>
<td>26.6</td>
<td>1.4</td>
</tr>
<tr>
<td>FY 2021E</td>
<td>316.0</td>
<td>40.0</td>
<td>19.1</td>
<td>7.1</td>
<td>60.1</td>
<td>18.8</td>
<td>2.0</td>
</tr>
<tr>
<td>FY 2022E</td>
<td>333.6</td>
<td>48.6</td>
<td>23.2</td>
<td>8.6</td>
<td>70.6</td>
<td>15.5</td>
<td>2.4</td>
</tr>
</tbody>
</table>

Source: Radnor Capital Partners

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

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

16th March 2021

Iain Daly

id@radnorcp.com

+44 (0) 203 897 1832

Radnor Capital Partners Ltd is regulated and authorised by the FCA. Please refer to the regulatory disclosures at the end of this note.
Q1 trading update

Below are the key highlights for the three months ended 28th February 2021.

- Overall net fee performance ahead of management expectations. Traditionally, Q1 is the seasonally weakest quarter (in FY’19 Q1 accounted for 23% of full year net fees);
- YoY net fee growth in Q1 was flat (adjusted for one fewer working day than Q1’20), and up 1% on an absolute basis (-1% constant currency). This is especially notable as the prior year comparative (with the exception of APAC) was largely free from pandemic disruption at that stage;
- Two of the five largest key markets; DACH (+3% YoY) and USA (+19% YoY) are now back in positive year on year territory. Collectively, these two markets accounted for 60% of group net fees.
  - DACH (+3% YoY) was a notable performance, especially when set against a touch prior year comparative, which itself was up 9%. This +3% Q1 performance compares to a -2% in Q4 and -9% in Q3. Life Sciences (+7%) and Technology (+14%) were the strongest areas of growth.
  - USA (+19% YoY) was the second consecutive quarter showing healthy double digit growth following the +11% recorded in Q4. Similarly to Germany, Life Sciences (+25%) and Technology (+43%) led the way.
  - EMEA (excluding DACH) remained in negative territory (-14% YoY) although there continues to be a material sequential improvement on Q4 (-20%) and Q3 (-22%). The Netherlands (the largest country in this segment) delivered +1% YoY growth following a -13% decline in Q4.
    The UK, although still a challenging market, saw a -16% YoY decline in Q1 compared to a -24% decline in Q4 and a -28% decline in Q3. Anecdotally, SThree appears to be outperforming the broader UK market. Structurally, IR35 continues to have a negative impact in the UK across the market.
  - APAC posted a -14% YoY decline in Q1, a material improvement on the -30% decline posted in Q4 and -27% on Q3. This is the most Perm focused of all SThree’s key regions. More recent new deal activity has seen a good pick up and the outlook for Q2 is for continued improvement.
- The value of the Contractor order book (the total value of all contract placements) also showed a sharp improvement and returned to growth (+1% YoY), which compares to -9% YoY as reported in Q4. This points to both an improvement in both new deal momentum and contractor retention rates (which improved from 88% in Q4 to 90% in Q1).
- Period-end headcount was down 17% YoY, although the prior year comparative was distorted by the fact SThree entered the pandemic as the only one in the immediate peer group investing in its headcount. Headcount reductions have not been uniform across the group, varying according to specific local conditions.
- Closing net cash at 28th February was £57m, leaving the balance sheet in a healthy position. Outside of the soon to expire (and undrawn) CCFF facility, SThree maintains a £50m RCF and a £5m overdraft facility.
Estimate upgrade to FY’21 PBT and EPS (+11% / +8%)

In Figure 1 below, we detail our estimate changes post the Q1 trading update.

**Figure 1:** Radnor estimate changes

<table>
<thead>
<tr>
<th></th>
<th>Previous FY’21E</th>
<th>FY’22E</th>
<th>New FY’21E</th>
<th>FY’22E</th>
<th>Change, %</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Group Gross Revenue</strong></td>
<td>1,226.3</td>
<td>1,320.6</td>
<td>1,239.1</td>
<td>1,334.5</td>
<td>+ 1%</td>
</tr>
<tr>
<td><strong>Group Net Fees</strong></td>
<td>312.7</td>
<td>330.1</td>
<td>316.0</td>
<td>333.6</td>
<td>+ 1%</td>
</tr>
<tr>
<td><strong>EBITA</strong></td>
<td>36.9</td>
<td>46.2</td>
<td>40.8</td>
<td>49.4</td>
<td>+ 11%</td>
</tr>
<tr>
<td>- margin %</td>
<td>11.8%</td>
<td>14.0%</td>
<td>12.9%</td>
<td>14.8%</td>
<td></td>
</tr>
<tr>
<td><strong>Adj. PBT</strong></td>
<td>36.1</td>
<td>45.4</td>
<td>40.0</td>
<td>48.6</td>
<td>+ 11%</td>
</tr>
<tr>
<td><strong>Adj. EPS (p)</strong></td>
<td>17.7</td>
<td>22.3</td>
<td>19.1</td>
<td>23.2</td>
<td>+ 8%</td>
</tr>
<tr>
<td><strong>Dividend (p)</strong></td>
<td>6.6</td>
<td>8.3</td>
<td>7.1</td>
<td>8.6</td>
<td>+ 8%</td>
</tr>
<tr>
<td><strong>Net Cash (Debt)</strong></td>
<td>51.0</td>
<td>62.0</td>
<td>55.5</td>
<td>68.3</td>
<td>+ 9%</td>
</tr>
</tbody>
</table>

Source: Radnor

At the headline level we are pencilling a small upgrade to our net fee expectations for both FY’21 and FY’22 net fees. The larger impact comes further down the P&L where we have upgraded our conversion margin expectations. There are two key dynamics at play here:

- **Absolute net fee momentum.** The 1% YoY growth in the Contractor Order Book (the current overall value of contractors placed), is the first time this has been in positive YoY territory since the start of the pandemic and is an important metric as this represents a clear picture of improving visibility. It should be stressed again that this 1% growth is against a pre-Covid comparative. Anecdotally, the company has been talking to a strong up tick in new deal activity, which picked up during Q4 and has been maintained through Q1.

- **Productivity momentum.** Q4 saw a material improvement in overall productivity, above and beyond the natural drop through effect from a more stable net fee performance. Reading between the lines of the Q1 update we see SThree benefiting from some material shorter term margin gains. The group has reduced costs and headcount selectively through the crisis, which has seen under-utilised capacity being taken out of non-core markets (primarily). The fact that two of SThree’s key markets have now returned to absolute YoY growth suggests that this overall cost control has been achieved without diminishing the ability to secure new business. Management have also spoken about their response to the pandemic demonstrating new ways and models of working that point to a more efficient model looking forward.

The key question for investors will be the how much of these margin gains can be maintained as the group fully exits the crisis and returns to the pre-pandemic growth investment mode.
Although SThree has seen a return to absolute growth in two of its key markets; overall net fee levels are now in line with the FY’20 comparative, which remains positive when it comes to working capital release and net cash expectations. We are therefore increasing our FY’21 net cash expectations to £55.5m (£51.0m prior expectations). Group net cash at the end of Q1 was £57.0m.

Our clear expectation is that YoY growth will continue to recover, and if this proves to be the case then we expect the traditional working capital dynamics of the contract business to re-assert themselves and SThree become a net investor in working capital to support net fee growth. Based on our current estimates, we anticipate an FY’21 working capital outflow of £13.0m, compared to an inflow of £25.3m in FY’20 during the peak of the pandemic contraction.

At the November 2019 Capital Markets Day, SThree outlined how working capital management and efficiency was a key area of focus for them. Pre-pandemic, SThree had established a good track record of growing working capital as a percentage of gross sales at a slower rate than net fee growth. We continue to expect this historic trend to reassert itself once the pandemic induced working capital volatility has washed through the numbers.

Looking beyond any further pandemic induced volatility; the only material headwind facing the group is likely to come from FX. A prolonged period of GBP strength (relative to the Euro especially) could impact net fees / EBIT by 2% - 4%. We will reassess the FX impacts at the half year.
Performance relative to the peer group

Below, we update our peer group comparison charts following the SThree Q1 trading update. As a reminder, SThree has a November year end and is the first of the peer group to report on Q1 progress.

**Figure 2 & 3:** Quarterly Net Fee trends, YoY growth – SThree vs UK Staffing peer group

![Graph showing quarterly net fee trends from Q4 '15 to Q1 '21 for SThree and the peer average, with a legend for SThree, Peer Average, Hays, Page, and Robert Walters.]

*Source: Company announcements, Radnor*

In Figures 4 and 5 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 4:** Contract Net Fees, YoY growth

![Graph showing contract net fee trends from Q4 '15 to Q4 '20 for SThree, Hays, and Page, with a legend for SThree, Hays, and Page.]

*Source: Company announcements, Radnor*

**Figure 5:** Perm Net Fees, YoY growth

![Graph showing perm net fee trends from Q4 '15 to Q4 '20 for SThree, Hays, and Page, with a legend for SThree, Hays, and Page.]

*Source: Company announcements, Radnor*

Unsurprisingly, SThree has seen its most pronounced outperformance in the Contract business. However, we do note that peer trading commentary has 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 for SThree and have benefited from the relative strength of these specific labour markets through the pandemic.

2. Secondly, SThree’s strategic focus on STEM industries and roles is equally applicable within their Permanent businesses and will have provided a degree of protection from the worst cyclical effects of the downturn as these industries have, by and large, outperformed their domestic economies.

In Figures 6 and 7 below, we show the quarterly YoY net fee growth for the USA (compared to Hays and Page) and the UK.

The UK performance is especially notable as this is a market that has historically been seen as a source of comparative weakness for SThree. Indeed, we can see that through 2016 to 2019, SThree did underperform in the UK compared to the peers. However, since Q3 2019, SThree’s UK business has actually held up better than its peers (only Hays has seen a sharper recovery out of the pandemic trough). In a similar fashion to SThree’s experience in other markets; the combined emphasis on contract roles and technical end niches has held the UK business in relatively good stead.

The US is the market that shows perhaps the largest disconnect to the UK peer group; with SThree now showing healthy mid-teens YoY growth. At the lowest point; Page saw their US business decline by 57% year on year, while Hays was down 23% YoY. The lowest point for SThree was Q3 2020 which was down 4% YoY.
Peer group valuation

Below, we show the 2022 PE multiple for both SThree and the UK Staffing peer group (Hays, PageGroup and Robert Walters).

![Figure 8: 2022 PE multiple - SThree vs peer group](image)

![Figure 9: SThree PE discount / premium to peer group](image)

Source: FactSet

We can see from Figure 9 above, that although SThree’s PE discount to the peer group has narrowed over the last six months, it remains in line with the pre pandemic range (20% - 35%). We believe the market is looking to a sharp cyclical rebound which, on paper, should flatter the more transactional, perm heavy peers. In this context we note SThree’s Permanent net fee income has outperformed peer group Perm net fees through this pandemic (see Figure 5 above). We see no reason why this should not continue as SThree’s STEM specialisation focuses it on areas of relative economic strength.

In Figure 10 below, we show the extent of PBT estimate revisions over the last six months. We can see that SThree has been upgraded more than any of its supposedly more cyclical peers. In Figure 11 we show the extent to which current PBT estimates have fallen from their peak over the last two years. This shows that SThree’s current 2021 consensus is -18% from its peak, this compares to an average of 60% for the peer group.

![Figure 10: 2021 PBT revisions - last six months](image)

![Figure 11: 2021 PBT - decline from peak estimate](image)

Source: FactSet
SThree PLC
Iain Daly
+44 203 897 1832
idl@radnorcp.com

PROFIT & LOSS
Year to 31 November, £m 2017 2018 2019 2020 2021E 2022E

Group Sales 1,114.5 1,258.2 1,324.7 1,202.6 1,229.1 1,334.5
EMEA (ex DACH) 129.0 142.0 141.2 117.6 116.7 122.6
DACH 80.9 99.3 109.3 105.8 109.1 114.6
USA 64.4 66.6 76.7 77.2 81.8 87.8
APAC 13.7 11.3 11.6 7.9 3.8 3.2

Group Net Fees 287.6 321.1 338.0 308.6 316.0 333.6

EBITDA 50.7 60.1 62.8 58.7 59.4 67.0
Depr & Amort (5.7) (6.1) (6.0) (6.4) (6.6) (6.6)
Lease Depreciation - - (13.0) (12.0) (11.0) -

EBITA - Adjusted 44.9 53.9 60.0 45.3 40.3 49.4
Associates & JV's (0.1) 0.1 - - - -
Net Bank Interest (0.3) (0.7) (1.0) (1.2) (0.8) (0.8)

PBT - Adjusted 44.5 53.3 59.1 30.1 40.0 48.6
Non Operating items (6.7) (6.4) (2.3) (1.3) - -
Other Financial items - - - - - -

PBT - IFRS 37.8 46.9 56.8 28.8 40.0 48.6

Tax - Adjusted (11.4) (13.9) (15.9) (11.7) (14.0) (17.0)
Tax rate - Adjusted 25.6% 26.0% 26.9% 39.0% 35.0% 35.0%
Minority interests - - - - - -
Net Profit, m, diluted 132.6 133.1 133.6 136.4 136.4 136.4

Adj EPS (p), diluted 24.9 29.6 32.3 13.5 19.1 23.2
Total DPS (p) 14.0 14.5 5.1 5.0 7.1 8.6

CASH FLOW
Year to 31 November, £m 2017 2018 2019 2020 2021E 2022E

EBITDA 50.7 60.1 62.8 50.9 59.4 67.0
Working Capital (16.4) (25.3) (13.3) 25.3 (13.0) (8.5)
Provisions / Exceptionals 5.8 (4.7) 3.6 0.8 (0.8) (0.8)

Gross Op Cashflow 40.1 30.1 53.2 76.9 45.6 57.8
Cash Tax (10.9) (14.4) (13.0) (10.5) (11.7) (14.0)
Cash interest - - - - - -
Cash Profit, m, diluted 132.6 133.1 133.6 136.4 136.4 136.4

Net Op Cashflow 28.9 15.2 40.2 66.5 33.0 43.0

Capex (5.8) (5.2) (4.6) (5.2) (5.3) (5.3)
Free Cashflow 23.1 10.0 35.7 61.2 27.8 37.7

Dividends (18.0) (18.0) (18.8) (6.7) (6.8) (9.6)
Acquisitions & Inv. (1.2) - - - - -
Other Non Operating (8.3) (2.6) 0.4 (13.3) (13.3) (13.3)

Net Cashflow (4.4) (8.2) 17.3 41.3 7.5 14.8

Net Cash (Debt) 5.6 (4.1) 10.6 49.9 55.5 68.3

BALANCE SHEET
Year to 31 November, £m 2017 2018 2019 2020 2021E 2022E

Intangibles 11.4 9.6 8.0 4.4 4.4 4.4
PPE 6.7 6.9 6.8 40.8 42.1 43.5

Tax Asset & Other 6.0 4.7 4.2 1.5 1.5 1.5

Total Fixed Assets 24.1 21.3 19.0 46.7 48.0 49.4

Current Assets 238.1 288.4 271.0 257.4 254.0 273.5

Current Liabilities (174.9) (202.3) (182.3) (179.5) (183.1) (194.1)

Net Current Assets 53.2 86.1 88.6 57.9 70.9 79.4

Long Term Liabilities (2.2) (1.6) (1.4) (26.0) (26.0) (26.0)

Net Assets 80.7 101.6 116.9 128.5 148.5 171.1

PRICE CHART - 2 YEAR ABSOLUTE vs FTSE ALL SHARE

SThree PLC

SHAREHOLDERS
% of ord. Share capital

JO Hambo Cap Mgmt 8.4%
ST three Founders 7.6%
Kempen Cap Mgmt 6.2%
Fidelity 5.8%
Allianz Global 4.8%
Harris Associates 4.6%
Polar Capital 4.1%
41.5%

Announcements
Date Event
15 March 2021 Q1 trading update
14 December 2020 Q4 trading update
23 November 2020 Positive trading update
14 September 2020 Q3 trading update
20 July 2020 Interim results
15 June 2020 Q2 trading update

RATIOS
2018 2019 2020 2021E 2022E

RoE 38.8% 36.9% 14.3% 17.5% 18.5%
RoCE 51.1% 56.5% 39.8% 43.9% 48.1%
Asset Turnover (x) 0.1x 0.1x 0.2x 0.2x 0.1x
NWC % Revenue 6.8% 6.7% 4.8% 5.7% 6.0%
Op Cash % EBITA 55.8% 88.5% 245.7% 111.7% 116.9%
Net Debt / EBITDA 0.1x -0.1x 0.2x 1.0x 0.9x

VALUATION

P/E 12.1x 11.1x 26.6x 18.8x 15.5x
EV/EBITDA 7.1x 6.8x 8.4x 7.2x 6.4x
Div Yield 4.0% 1.4% 1.4% 2.0% 2.4%
FCF Yield 2.3% 8.3% 14.3% 6.5% 8.8%

Net Fees growth 11.6% 5.3% -8.7% 2.4% 5.6%
EPS growth 18.9% 9.0% -58.3% 41.4% 21.6%
DPS growth 3.6% -64.8% -2.0% 41.2% 21.6%