Investors' Chronicle | Alpha

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Alpha shares analysis

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There isn't always gold at the end of the rainbow

After a stock has been through a very strong rally deciding whether or not to invest can be a fine call and momentum investing can be risky even when so far only smaller gains have been made. To make the decision to invest there must be sustainably improving fundamentals, a solid investment story and evident value should always still be present: that can still be the case even after a stellar share price rise. In two of the three stocks this week (from our recent earnings upgrade momentum screen), we do still see value while the other is more likely only to be riding an economic anomaly.

- **Cake Box** – this growing franchise business that sells egg-free cakes for special occasions offers a long horizon of EPS growth on a number of fronts. Smart physical expansion and a long maturity profile for existing branches should drive EPS growth of more than 20 per cent for at least three years. Previously unknown and misunderstood, this interesting business still looks to offer value.
- **SThree –** this is where we see a stock that has risen on short-term gains arising largely from an economic anomaly, namely the labour shortage that has largely sprung from the Covid crisis. This will pass and the current high momentum of job movements may only last until the end of 2022, essentially within sight of the market's investment horizon. Recruitment is a feast and famine sector: we are in the former and one should invest during the latter.
- **Renewi –** waste management and recycle/reuse of domestic and commercial materials give Renewi strong green credentials. Augmenting solid market drivers is a three pronged strategy aiming to almost double EBIT by 2025. A checkered trading history has sown market mistrust of that objective being met but a very strong upgrade cycle suggests Renewi will deliver this time. This is not yet fully reflected in the rating even after the share price has quadrupled.

Analyst: **Robin Hardy**

Cake Box – box of delights

Source: FactSet

Cake Box is a unique proposition in the London equity market - it is a franchisor for a growing chain of specialist shops selling egg-free, fresh cream cakes. Starting from a single outlet in East London in 2008, CakeBox had expanded to 91 franchised outlets by the time of its IPO in 2018 and now has 166 stores. Outlet count is rising at around 20-25 per annum with a current target to open 250 main store outlets in the UK, excluding ' kiosk' outlets (see later).

The plc does not directly run any of the customer facing outlets, instead operating a tightly controlled franchise model with tied supply arrangements for the base cake sponges, frostings (almost always fresh cream), decorations, packaging and ancillary items (such as candles). Unlike most franchisors, Cake Box does charge a management service fee (MSF) instead deriving its revenues through initial franchise sales (typically £125,000) and the tied supply chain. High level promotion and marketing are carried at the plc's expense with store operators required to undertake local marketing campaigns.

Why eggless cakes?

On establishing the business, the founders spotted a gap in the cakes market for those who could not (for medical or allergic reasons) or would not (for religious or environmental reasons) eat cakes made with eggs. The founders of the company have

South Asian heritage and were aware of the strong lacto-vegetarian eating requirements of many members of the community with the same ethnic origins (eggs are regarded by Hindus, for example, as living things so cannot, therefore, be vegetarian). The focus of 'free from' cakes is primarily wheat or dairy products so the group's proposition brings a different slant.

Although the cakes sold are vegetarian, they are not vegan because of the extensive use of cream. Some critics point to the high fat, cream and sugar content of the cakes but CakeBox is not aiming to deliver a healthy living product. Its products are celebration cakes intended to be eaten only occasionally on birthdays or anniversaries and there is no intention to try to enter the healthy eating market space: it is often best to keep the model simple.

Running out of road?

There might appear to be a finite scale for this business in its current form in terms of the footprint of franchised, main stores: if 20-25 stores are to be opened each year, the 250 outlet target will be hit in just four years. There could be scope to push beyond this number but that risks entering into diminishing returns and market oversaturation. If there is a ceiling on the demand for this type of cake within the existing customer base then over-saturating the market with outlets will not grow total sales , which in turn risks making each outlet less profitable, which would then sate the appetite for new franchisees.

What would then be the driver of growth if only a moderate number of additional outlets are opened? A number of initiatives have been put in place that will help to push up the average revenue per outlet (ARPO) by range extension but if two major planks of growth are removed (growing the number of outlets that are in the tied supply chains and loss of initial franchise fee income) it could appear that growth will slow right down. So what active steps are being taken to grow the ARPO?

- **Kiosks** - Cake Box has been trialing a format for some time of mini or sub outlets known as 'kiosks' which come in two formats. First, within local shopping centres or malls, the group plans to open retail merchandising units (RMU) that sit in the pedestrian areas of the centre rather than occupying a full retail unit: they aim to catch casual, passing trade. These will be run and supplied by local franchise stores and would most likely generate around half the revenue of a full store.
  Second, a number of smaller-scale units have been set up within supermarkets, typically taking the space freed up by the wide scale removal of delicatessen, fishmonger and butchers counters within many food stores. To date five have been set up within larger ASDA stores with more expected there and across other

chains. For scale, ASDA has around 350 superstores in the UK, while Tesco has 795 larger format stores which could accommodate these.

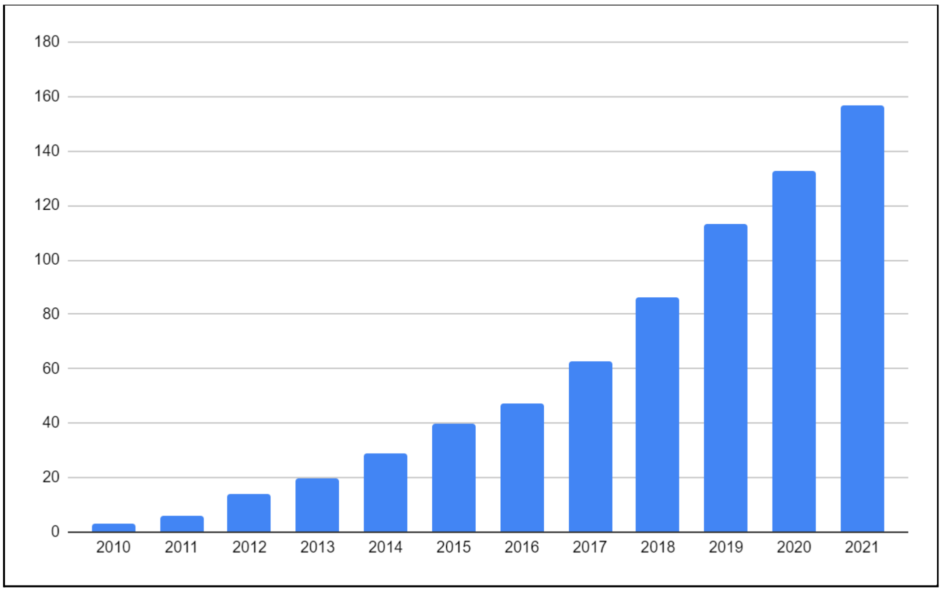
In early experiments, these additional outlets seem to generate not only truly incremental sales without cannibalisation but have also boosted brand awareness and increased both in-store and online sales at the full store operating the kiosk.

Although the board is a little coy on timescale and ultimate numbers, it is likely that 150-250 kiosks will be added to the store portfolio and most likely rolled out much more quickly than the 15 years it will have taken to reach 250 full stores.

This broadening of the appeal and reach of the brand that is evident in the trials heads off one of the issues that troubled some investors at the IPO. There had been questions whether the business was limited to only too a small number of local communities and only a small, specific portion of the population.

- **Maturation cycle -** as with all branded stores or franchises, there is a maturation cycle before an outlet reaches its optimal revenue - Cake Box reckons it takes 5 to 7 years for its stores to reach maturity. Looking at the opening profile, that suggests only 40-50 of the more than 160 outlets have to date reached optimum sales. This is underscored by the still strong like-for-like sales figures running at around +15 per cent, which suggests there is still plenty of growth to be had.

Figure 1: Full outlets in operation at year end



Source: Cake Box

- **Online sales** - in the last full year online cake sales rose by 71 per cent against in-store growth of 7½ per cent (total franchisee sales rose 43 per cent) - some of this in 2020/21 will have been cannibalisation as in-store sales will have been impacted by Covid. Nonetheless, growth in online sales has been running at c.25 per cent for some time and looks likely to continue.

- **Home delivery -** augmenting its own online sales, which are primarily click-and-collect but also some own deliveries (about £1m per annum), Cake Box is now also using Deliveroo, Just East and Uber Eats for home delivery. This has rapidly eclipsed own-delivered orders and by March 2021 the run rate was £4.5m per annum. A downside with all delivered products is the additional cost and risk of lower margins. The various household name delivery companies will charge around 13 per cent of the order value which has to be met somewhere in the value chain. As with most food outlets using these third party originators and deliverers, prices listed on the third party site will have a mark-up: a quick check on the Cake Box and Just Eat sites shows that prices are marking up by a similar percentage to the third party on-costs. This should ensure that margins are protected.

Avoiding the Dominos experience

The Cake Box franchise model has many similarities to that of Dominos with prescribed product ranges, store appearance and a central commissary providing base ingredients. In 2019, Dominos suffered something of a franchisee revolt over what was seen as over-aggressive expansion and cannibalisation risk: this arose largely because Dominos had allowed two franchise owners to amass almost 40 per cent of its total outlets. The board here is aware of these issues and is minded to limit the maximum scale of any one operator. At the end of last year, the top two operators were running just 15 outlets or less than 10 per cent of the total network.

Dividends

Being a franchisor is a capital-light and high free cash generating business model which should allow a generous distribution to be made to shareholders, leaving a decent yield. Cake Box, however, only provides a yield of around 1.5 per cent. This is more a function of the strength of the share price in the last year because the payout ratio here is a generous 50 per cent: not a lot more could be expected for a core or running dividend payment.

Cake Box is, however, coming to the end of a heavier investment phase (new distribution centres, commissary etc) and cash is expected to build up rapidly, perhaps hitting £10m (£3.6m at last year end) within three years. This suggests scope for special dividends or share buy-backs. The latter is preferable, in my view, as special dividends often leave no net gain for shareholders after the ex-dividend date whereas buy-backs bake in permanent EPS gains and can boost the share price.

Share price - from indifference to star status

The share price chart is an interesting one with what appears to be relative investor indifference before Covid with almost no change in the price after the initial post-IPO surge until the arrival of the pandemic. A strong rebound in store-based business levels post-Covid showed that the near halving of the shares was overkill, the model had proved itself to be robust, the start of online selling has been very successful and finally managing to breach the all important £100m market capitalisation mark brough the stock to the attention of much wider range of investors. The surge in the share price was much more than basic momentum, instead recognising that the somewhat dismissive view of many investors at the IPO was ill-placed and that this is a growth story.

Conclusions

Cake Box runs a simple but effective model - it bakes sponges and allows small entrepreneurs to make good returns selling a relatively unchallenged product range. Growth has been good since the 2018 IPO and there looks to be plenty left in the tank with like-for-like growth at 15 per cent and expansion now at a similar rate (and likely to accelerate). EPS growth is forecast in the consensus to be at a 21 per cent compound annual growth rate (CAGR) over three years.

Steeply rising share prices can be off-putting but the last year for Cake Box has seen a re-rating for an under-valued, somewhat misunderstood and widely ignored business. The PE may look relatively high after running up 120 per cent from pre-slump levels (and almost quadruply from the covid low of 100p) to stand today on a Year 1 PE of 28.5 times. While this is high against the wider market's 13 times, against the FTSE All Share Consumer Discretionary sub-sector's 23.2 times, the rating is less demanding.

A lot of the value has been consumed here already as the share price ran up but Cake Box could go higher, especially if there are more positive surprises on earnings in upcoming periods as the expansion is proven. The upside might only now be around 15-20 per cent but buy-backs could enhance that. As a consumer stock further lockdowns are a risk but given how well Cake Box emerged from previous shutdowns, any hit to the share price arising from additional enforced closure could be a great entry point.

Renewi – making something out of nothing

Source: FactSet

Renewi, a reincarnation of the former Shanks & McEwan, is a waste management business with a twist. Rather than simply managing waste to either landfill or incineration, it processes and recycles to produce reusable materials. It then resells these materials for re-use. The business was formed in February 2017 from the merger of Shanks with Van Gansewinkel B.V, a Dutch waste management operator that was more advanced in the recycling field. This makes the business part of the "circular economy" which is defined as a model of production and consumption, which involves sharing, leasing, reusing, repairing, refurbishing and recycling existing materials and products as long as possible. Renewi is known as a 'waste to product' business although it does not actually make end products, rather it provides the raw materials for a wide range of manufacturing processes.

Volatile share price history

Close to12 months after the merger the share price began a long, steady decline that ran for a little over a year and ultimately saw the price drop by close to 80 per cent. Thereafter, the price doubled up to the start of Covid before halving again. From a Covid sell-off low of 183p, the shares have since almost exactly quadrupled. However, it still stands more than 25 per cent below the share price at the time of the merger.

There were a number of issues driving the negative element of performance: lost trading momentum, profit warnings, disposals, provisions, persistent post-tax statutory losses, a rapidly eroding net asset value, slashed dividends, rising debt multiples and recurring exceptional costs all of which caused the market to lose trust in the business and to materially down-rate its stock. At the low point in 2019, the shares trading at 220p stood on a PE ratio of just 4 times on Year 1 EPS. The market has also consistently had to attempt to view trading on an adjusted earnings basis, which is not ideal, as there was always something new and material gnawing away at the reported profit.

The most significant trading issues were a series of onerous contracts (skewed towards the UK), loss making divestments and an issue with seemingly contaminated, recycled soil in Holland that arose from a small part of the business (called ATM) but that somehow lopped around one-quarter from overall group EBIT - this latter issue is still unresolved (see below).

Can Renewei's future be considered stronger and more reliable? Well, there are a lot of positive drivers being put in place both within the business itself and externally within the key markets.

Strong plans for self help

In its March 2020 results presentation Renewi revealed a tricorn strategy that aims to deliver growth in addition to any underlying market gains. Each of the three parts seeks to deliver €20m of incremental EBIT before 2025, a significant boost to profits if achieved. Underlying EBIT today is around €70-75m. Some €110m of additional investment will be required to pull this through, challenging for a business that already has fairly high debt (net debt = 3.3 times EBITDA including FRS16 leases) and where the EBIT outcomes are heavily back-end weighted with the 2025 target timeframe.

1. **Internal processes** - there are two elements here: 1) increase the rate of collected materials re-sold for reuse from 65 per cent to 75 per cent; 2) streamline and improve collection, handling and customer interaction by investment in bespoke IT solutions. Delivery of the €20m ramps up through to 2025.

2. **Innovation pipeline (Renewi 2.0)** - a wide array of new and/or refined recycling processes each programmed to deliver small to medium returns as scheduled below. This is where the bulk of the capital investment will be made. The €20m boost is expected to be hit as a run rate by the end of 2025. This programme will drag on the group by €2m in 2022, then rise by €2m, €9m and €19m in the following 3 years.

Renewi 2.0 innovation schemes with target EBIT uplift

ATM Gravel sand & filler	€5-6m
Organics > Biogas production	€2m
Organics > Biogas to Bio-Liquid Natural Gas	€3-4m
Expansion of plastic recycling	€3-4m
Vlarema 8*: Advanced residual waste sorting	€8-10m
Mattress recycling (in JV)	€5-6m
Feedstock for chemical recycling of plastics	€2-5m
Polyurethane recycling	€2-5m
Wood flakes for low-carbon steel	€4-8m

Source: Renewi * *Vlarema is a upgraded recycling policy in Wallonia, the French speaking part of Belgium*

Getting ATM back on track - ATM is the part of Renewi that has had to close down because of the soil contamination issue in Holland. This is a hazardous waste handling business that primarily takes soil that has previously sat under the likes of chemical plants or oil refineries and is required to be stripped and cleaned-up prior to reuse as either soil or lightweight manufactured aggregate. As land reclamation is a big issue in the Netherlands, there is a high and steady long-term demand for soil. The entire soil heat treatment sub-sector had been suspended (since early 2019) but is slowly reopening, now requiring local authorities to begin granting permits again. The €20m of extra EBIT here is forecast to flow in FY2023 and looks to be on track.

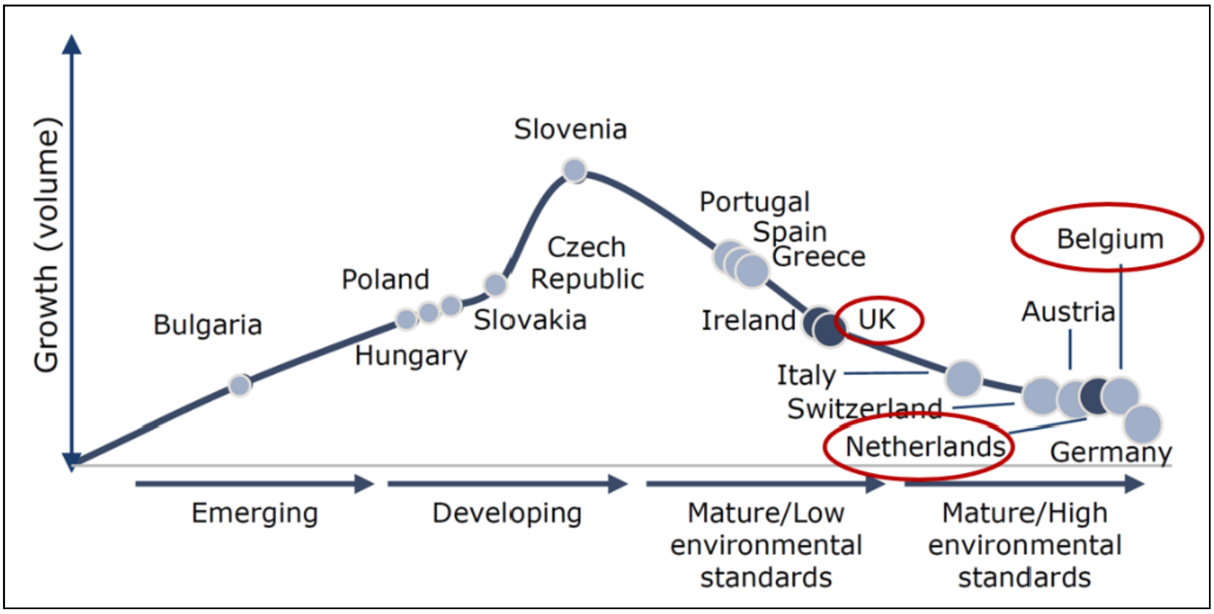
Market tailwinds

Any alignment with carbon reduction has to be seen as a positive for any business and the activities of Renewi are focused on almost nothing else. The pressure to recycle and reuse a wide range of materials, not just plastics, is only going to increase with the European 2050 net zero carbon target edging closer. Germany remains the exemplar in the development of a circular economy with the group's primary markets of Holland and Belgium not far behind. Growth in these markets is expected to still run comfortably above the underlying rate of GDP growth for many years despite relatively mature markets.

The UK (c. 12 per cent of revenue) is still a poor circular economy by Western European standards with much of the country's domestic and commercial waste still being incinerated rather than re-used. This is a step up from using landfill (still heavily used despite high taxes) which was a mainstay of the old Shanks business.

While there are no immediate plans to move into new territories this always remains a possibility as a bolt on to existing growth drivers. Any such expansion is more likely to be in joint venture with established local operators; or following the lead of an end user client of recycled materials or a manufacturer taking greater control at the end-of-life of their products. On that latter point, there is a now Europe wide JV with IKEA for the recycling of mattresses (Part of Renewi 2.0 outline above) which could prove a useful template for other more responsible businesses. To date, no forecasts reflect any meaningful contribution from such developments.

Figure 1: Growth potential vs current environmental standards



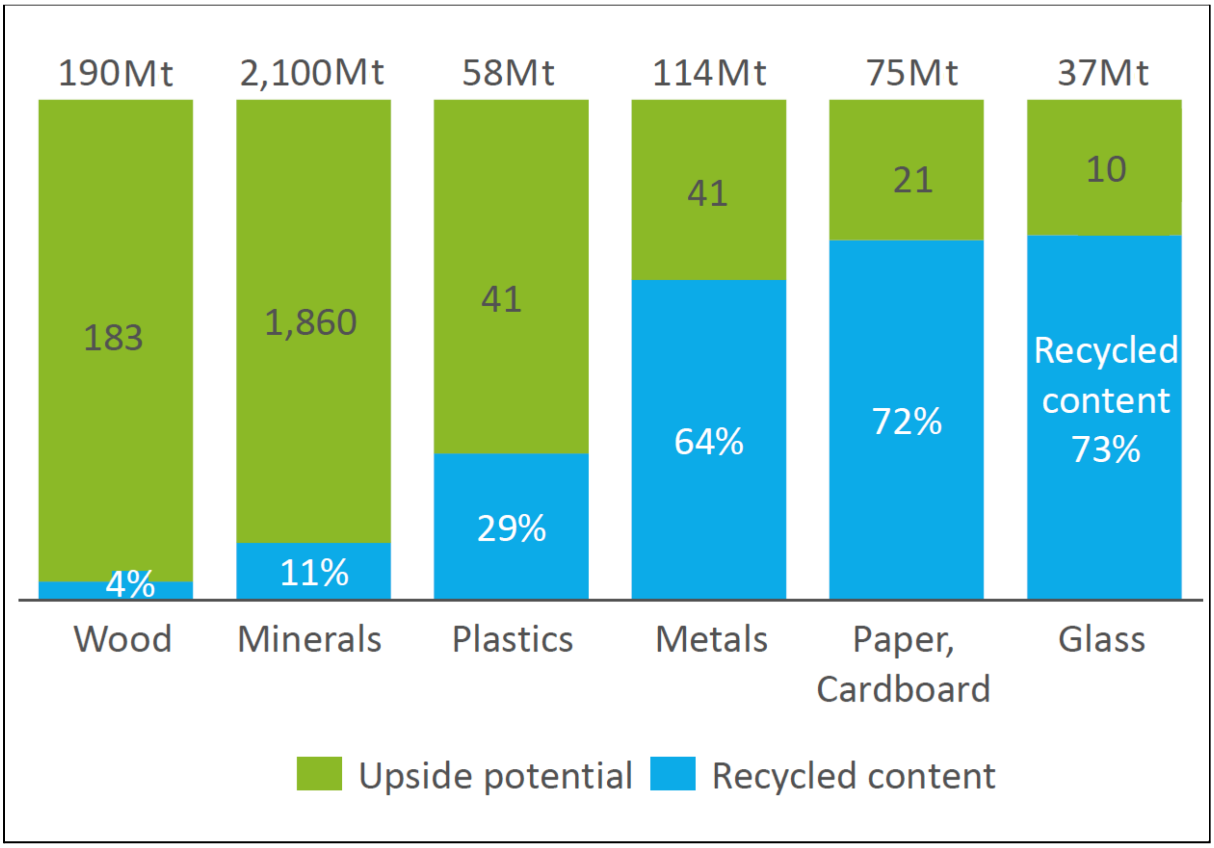
Source: Renewi

As shown in Figure 2, the recycling of many materials still lag behind the leaders such as glass, paper and metal which shows that even within seemingly mature reuse markets, there is a lot of potential for growth. Some markets are more difficult to operate profitably due to the low cost of the materials (ie minerals such as sand - selling for €10-12 per tonne ex-works versus €1,400 per tonne for aluminium) which in some cases can be negative net of processing costs. For these products use of recycled materials will have to be forced by regulations or more aggressive effective pricing of carbon or other environmental taxes.

Any financial benefits that accrue for macro changes in recycling & re-use or rising prices of re-processed materials as taxes rise on some virgin materials would be in addition to the €60m of additional profit from the three-pronged self-help programme. Such changes in the balance of new or reused materials typically follow political agendas which may clash with commercial objectives, for example a requirement to recycle low value material. This could drag on margins despite incremental gains in profit.

Externally driven factors can also create lower quality earnings (such as inflation boosting house builders' profits but lowering their ratings) and can easily be de-emphasised or totally disappear as political winds change. Given the history of disappointments here, Renewi's management is right to focus the market's attention on the greater value-added in self-help.

Figure 2: Material use in the EU (m tonnes per annum)



Source: Renewi

Conclusions

If Renewi can deliver the promised €60m of additional EBIT from its internal initiatives and assuming underlying profitability is sustained, then PBT (assuming no more substantial exceptional items) could be heading over €100m by 2025: this is a CAGR of 21 per cent. On that basis, EPS could rise from 2021's basic 64¢ to 94¢. There are quite a few 'if' and 'howevers' to overcome here though. First, 2025 is a long way off and the maximum market visibility is really only as far out as 2024 (and even that is a stretch for valuation purposes). Edison and Peel Hunt both estimate 80¢ of EPS for 2024.

Second, there is still a lot of normalisation of earnings going on to reach that 80¢ as these consensus forecasts still deduct exceptional costs and goodwill amortisation. It might be normal to exclude exceptional costs but in Renewi's case these seem to be perpetual so they perhaps should not be left out. Goodwill helps give a fairer reflection of what it costs to deliver the profits so there is also a strong case that this should also be left in.

Unadjusted or statutory EPS moves from 64.1¢/73.6¢/80.2¢ to 47.3¢/54.3¢/68.5¢ for 2022/23/24 on Edison's forecasts.

Third, these forecasts assume that the promised €60m of additional EBIT is largely on track for delivery by 2025. There is a lot of water to flow under the bridge before then and Renewi is still not especially well trusted by investors and does have something of a checkered history.

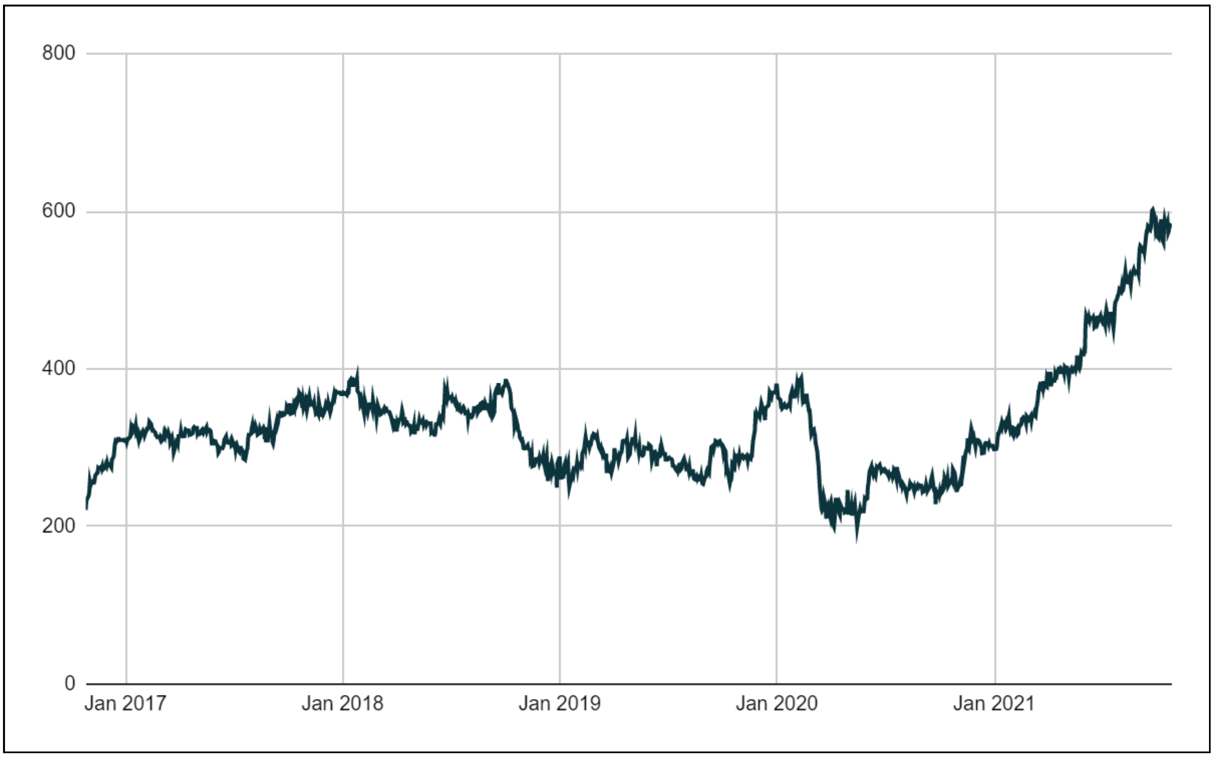
That said, if these forecasts are correct (and note that forecasts from Peel Hunt have been increased no less than six times since the Covid lows in Q2 of 2020) the stock does look relatively cheap, even after more than tripling. The PE on the adjusted 2023 EPS is 12 times or on the statutory EPS, 16 times plus the dividend is set to restart and yield should be around 2 per cent. Go a year further out of the statutory PE drops to 12.9 times, which is relatively low for the likely rate of growth. Plus, these earnings assume little additional profit from market tailwinds and we cannot ignore that there has been a strong upgrade cycle running for more than 18 months, indicating that analysts might still be pulling their punches on their estimates.

Finally, if Renewi can continue to deliver, avoid the banana skins and bring exceptional charges down to minimal levels the market may be able to forgive and forget previous upsets and eliminate the long-standing discount within the equity valuation.

Analysts are bullish here and with good reason. The highest target price is set at 1080p (45 per cent upside implied) which feels rather punchy while others suggest around 850p as fair value. That is still a potential 15 per cent gain, which is probably worth pursuing. Any investment can also be made with a clearer conscience as this stock rates very highly on environmental, social and governance (ESG) measures.

Continued below

SThree – the best of times, the worst of times



Source: FactSet

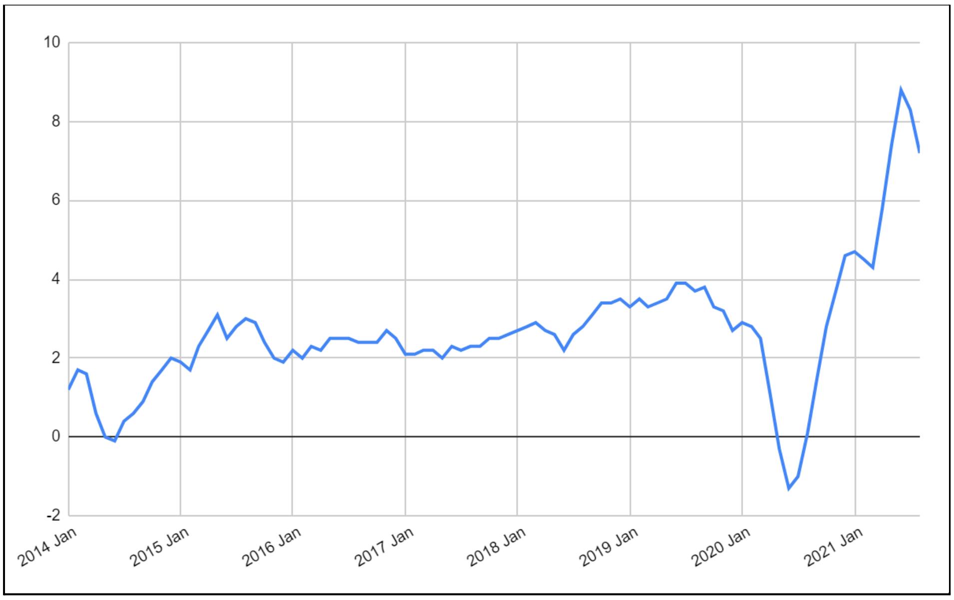
2021 is proving a perfect storm for the recruiters - a high surplus of jobs, staff shortages, high inflation and premium wages. When there are more unfilled jobs, especially in the professions (accounting, banking, legal, surveyors, IT, biotech etc) the faster the merry-go-round rotates and the greater the number of empty seats there are to fill. Plus in a job market with slack, every job move tends to create several others in its wake.

Recruitment consultants get paid by both the volume of placements they undertake and the wage that the job commands - for every job filled a fee of at least 15 per cent of the first year's wage is payable - so rising wages are a boon. For many businesses rising wages are a burden (on top of the soon to be increased employers' national insurance) but for the recruitment industry, this makes for the best of times. General inflation is already running at 3 per cent and (according to Andy Haldane at the Bank of England) heading to 5 per cent and the ONS reports that wage growth across the UK has broken its banks.

Salary increases have stepped out of the tight band of 1-3 per cent seen across the previous seven years, peaking at almost 9 per cent in June, although it has now dropped back to 7 per cent. This is not a broad rate of wage growth, however, but is skewed by several industries and professions running at much higher rates (see Fig 2).

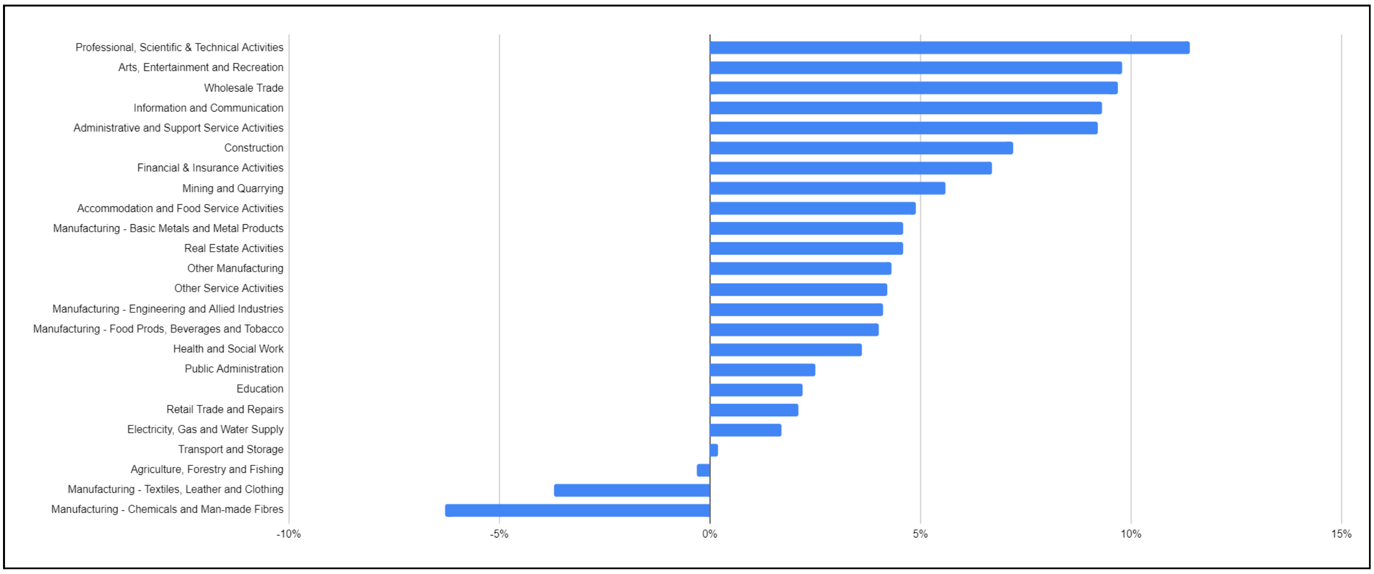
While we are using statistics here from the UK, the same broad experience is being felt in other larger economies across the globe.

Figure 1: Wage growth - whole UK economy



Source: ONS

Figure 2: UK wage growth by industry



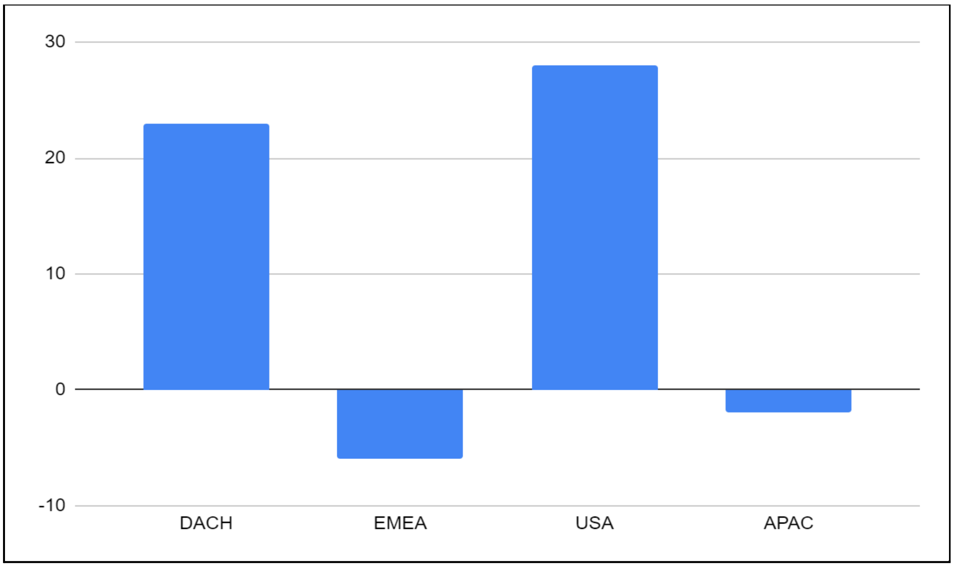
Source: ONS

SThree is one of the larger recruitment consultants which operates primarily in Northern Europe and the USA, and has benefited from these positive market trends and it has seen its share price rise three-fold since the Covid lows in Q2 of 2020. This has been driven by four increases in EPS guidance from the company in the last 12 months as fee income from new job placements has exceeded expectations.

So, how well is SThree faring? The only realistic way to look at true momentum in this business is to look at 2021 against 2019: looking at 2020 comparables, as in most industries, provides too much rebound or false momentum. The latest trading update from SThree (for its Q3) suggests that momentum is improving as 2021 progresses - in Q1, fee income was 1 per cent below 2019, in Q2 it was 8 per cent above and by Q3 it was ahead by 11 per cent. That growth, however, is not evenly spread across the group's theatre of operations (see Figure 3): the strongest region is the USA followed by DACh (Germany, Austria, Switzerland) both up by more than 20 per cent.

Latest data from the USA indicated that there were 10.4 million job vacancies in August, down from 11.1m in July (the US workforce totals 164 million for context), but that only 6.3 million new hires were recorded in the last month. Wage growth in the US is slowing, having peaked at 14.5 per cent in April but is still above 9 per cent.

Figure 3: Regional performance - fee income Q3 2021 vs Q3 2019



Source: SThree

Germany is the group's largest European market and here (as in many other western economies) there is a lack of population growth leading to a heavier reliance on immigration. The German government highlights a structural problem with a shrinking indiginous workforce (by 150,000 a year) that needs topping up with 400,000 imported workers every year and that need is not being met. Wage growth is less pronounced (there has been an unusual disconnect with high employment and low wage growth across the EU) but stands at a 25 year high of 3 per cent and looks still to have momentum. Trends here may remain positive.

Recruiters are businesses that have very elastic operating models. The businesses can expand and contract very easily without leaving big holes in profitability when the good times disappear but they can still make much better profits when times are good. They can flex considerably without needing to add to their central costs and get left high and dry when things turn down.

Figure 4: Source location of SThree's fee income

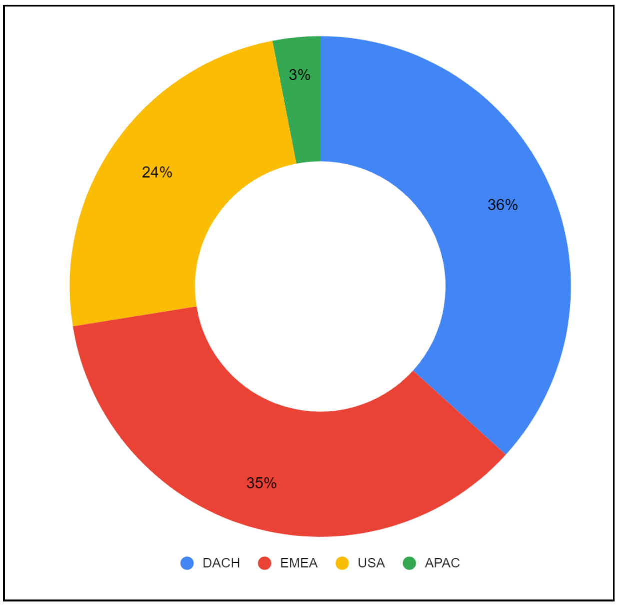
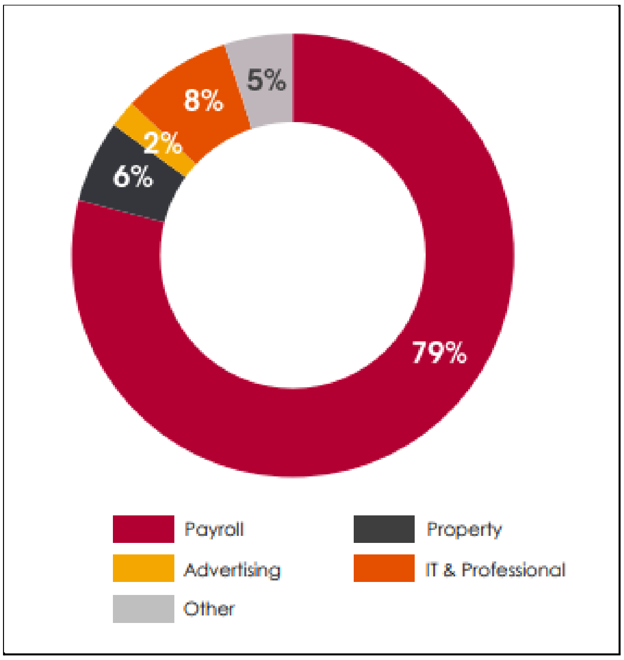


Figure 5: Cost structure of SThree - H1 2021



Source: SThree

SThree's cost structure is shown in Figure 5. There is a relatively low level of fixed cost and much of the salary cost is variable - recruitment consultants are typically paid low basic salaries and high commissions. When the market is strong as it is now, this sector makes hay.

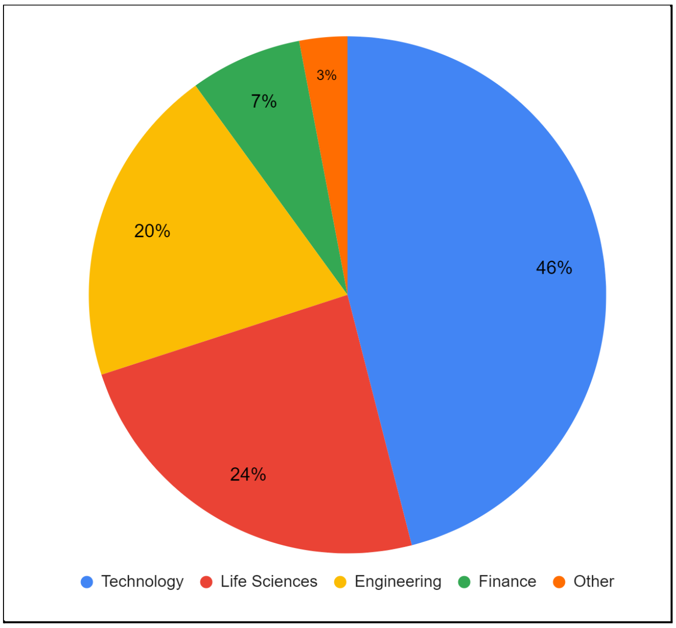
What has been the driving force?

The strength in trading at SThree has been driven both by the underlying market forces, by its own cost structures and by the strategy of positioning itself with a heavy bias towards STEM (Science, Technology, Engineering & Maths - the latter is also effectively technology but biased towards coding) disciplines.

1. **Self help** - earnings driven by strategy are worth considerably more in terms of equity valuation than those handed to a business by external factors beyond management control (a rising tide lifts all boats). Unfortunately it is hard to disentangle internal from external drivers but given the size of the waves in the labour market, those external factors feel much the larger influence at present.

   Because of the bias towards STEM disciplines, the quantum and quality of wage growth can be seen as higher than it might be for the likes of hospitality jobs. That is because there is a substantial, structural shortage of the right skills and the number of jobs is rising faster than the education system is pushing new staff into the market.

Figure 1: SThree: industries driving fee income



Source: SThree

SThree has also shifted its axis more towards short-to-mid term contract placement, which appears to be a more desired work pattern within STEM industries, and work flexibility is generally increasing across all industries and locales. This provides a greater momentum for fees generation and while each placement fee is lower than for a permanent position, overall revenue is higher. This working pattern and higher fee revenue has also been generated using a smaller staff headcount.

Market driven - more staff are being placed due to labour shortages and higher fees are able to be charged because they relate directly to salary levels. While wider market rises are good for the earnings level, these can have a negative impact on the quality of those earnings. In the same way that house price inflation boosts developers' or estate agents' earnings, the additional EPS is often seen as having a 'PE of 1'. The boost in SThree's recruitment fees from higher wages and market momentum are similar to this scenario and it is a fine call as to whether the rising earnings should be up-rated (as happened here) or down-rated to reflect lower quality of EPS.

Will the current market climate persist?

This is the big question: what will happen to the momentum of job changes and wage levels if (more likely when) the labour market shortages begin to disappear. It does not feel as if there is any immediate prospect of change but recent research by Goldman Sachs (although it was looking at the US, the principles apply across the G7 and G10 nations) suggests that the imbalances between job seekers and job openings will have normalised by mid-2022. That said, the research does suggest that in 2023 and 2024 the unemployment rate will drop below pre-Covid levels, so some pressure will remain. This might suggest that the rate of wage growth will subside but some positive drivers of wage levels are likely to remain.

- **Brexit departures** - only a problem in the UK but this does look to have created a permanent hole in the workforce. However, the UK is only 10 per cent of SThree's revenues so the impact will be limited.
- **Aging populations** - a global issue leading to the shrinking of the labour pool in western economies through retirement. Birth rates peaked in most of these countries around 1963 with the UK then seeing a drop of one third in the birth rate in the following 15 years. Retirees are not being replaced.
- **Wealth gains** - a halfway house to retirement for many workers following increased housing equity unlocking and other increases in personal wealth, this has led many to choose to work part time leaving more holes in the workforce.

- **Self employment** - this has increased during Covid-19, which has shrunk the pool of workers able to be placed. While lowering potential placements this will have added to wage pressures.
- **Covid-19** - isolation and other pressures are leaving places unfilled and making fewer people happy to move jobs.
- **Momentum** - when one employee is poached to change employer, a cascade of job changes tends to follow. This creates more placement opportunities but also often a virtuous circle for wages.
- **Wage chasing** - Higher wages create self-fulfilling momentum as those not even thinking of moving get sucked into the jobs market.
- **Unpopular jobs become more expensive** - where the job, employer or locale are less desirable wage levels need to be boosted to artificially to attract candidates in a tight market.

On the flipside, some factors may change the whip hand back to employers and relative pressure on wages

- **Furlough *et al* ending** - the UK scheme and equivalent job protection measures elsewhere have created a trap for many workers who might otherwise have moved. As these schemes end there may be a surge tide of those seeking to change employers. The same is likely to be true because of Covid-19.
- **Contract working** - Shorter-term contract nature of working allows employers to exert some pressure back on the price of labour as higher wages will have a shorter lifespan.
- **Remodelling businesses** - due to higher taxes, higher wages and more outsourcing or offshoring, many businesses will be looking to either eliminate positions or move to lower cost locations.

Conclusions

There are signs that the peak pressure on job rotation and wages may have passed but there is still significant tension in the labour market. While the momentum of new hires may decline to some extent, wages are likely to remain at elevated levels. As a result of this and the reported pace of SThree's reported trading, the consensus here feels too cautious with EPS estimates for the 2021 full year averaging 29.85p, which compares with 33.2p in 2019. H1 2021 was 10 per cent higher than 2019 so for that consensus to be correct H2 needs to be 22 per cent lower than in 2019: in Q3 momentum was building and Q4 (trading update is published on December 13th) is likely to be similarly positive.

Consensus for FY2022 looks similarly awry. The range is very wide from 29.1p (two analysts have this forecast which is below 2021 consensus) up to 35.6p with the average looking pretty meaningless at 32.3p; but this is again still below the 2019 level. Overall, the consensus looks cautious leaving ample scope for more surprises and/or upgrades.

Do positive surprises, however, automatically mean another kick up in the share price? No, because we often find ourselves in a position where, in effect, 'the market got it right', reflecting the actual outcome long before either management or analysts have voiced it or reflected it in their forecasts. The share price seems to be discounting that 2021 and 2022 will be ahead (possibly well ahead) of 2019 so that positive development in guidance and/or expectations looks already to be baked into the valuation.

So should investors consider SThree as a way to play the strength of the recruitment market? Most of the gains have most likely already been made here but with the forecasts lagging behind. While the shares do not look especially expensive, growth is likely to be tough after 2022 as momentum in the jobs market fades, 2023 could easily see EPS move backwards rather than forwards. This is something of a feast or famine industry and we are in (and towards the end of) a feasting period and a better time to buy is before good times are in sway.

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