

Michael Hill Intl

NEUTRAL

1Q20 Sales — Improving Clarity

We upgrade Michael Hill (MHJ) to **NEUTRAL** from **UNDERPERFORM**, following a strong 1Q20 with evidence of execution on management's turn-around strategy. MHJ reported a strong 1Q20, with sales growth recovering strongly following a weak prior period. We are encouraged by (1) productivity improvements in Canada, (2) market share gains across all markets, and (3) margin commentary. We recognise that MHJ is in the early stages of its turnaround and that market conditions in Australia remain challenging, however, trading at ~10x forward PE, we believe investors are compensated for this risk.

What's changed?

- **Earnings:** Material EBIT upgrades; FY20E/FY21E/FY22E +10%/+11%/+14%
- **Target Price:** Increase to NZ\$0.70 from NZ\$0.50
- **Rating:** Upgrade to NEUTRAL from UNDERPERFORM

Strong start to the year

MHJ reported strong 1Q20 same store sales (SSS, up +12% against the prior year period and ahead of our expectations. The growth rate was helped by the weak comparable period where a strategic choice to reduce discounting activity impacted sales. Canada was a key highlight given management's focus on improving productivity, with 1Q20 SSS up +16% driven by early wins from new products and changes to its sales incentive scheme. New Zealand and Australia also achieved robust SSS growth up +10% and +7% respectively.

Margins improving but remain cautious amid competitive backdrop

Encouragingly margins across all markets saw a slight sequential improvement on 4Q19, although remain down on 1Q19. Branded collections as a portion of total sales (a key initiative to lift margins) maintained a positive trajectory, increasing to 38% (FY19 33%). However, market conditions remain challenging, particularly in Australia, where the highly competitive backdrop and store closures are driving elevated sector discounting. Given the importance of the Christmas quarter we expect more prevalent sector discounting as competitors look to capitalise on the inventory clearing opportunity, with incremental margin improvement in 2Q20 difficult.

Earnings upgrades

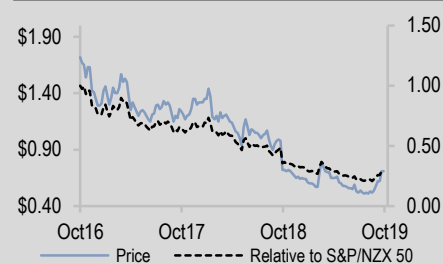
We expect sales growth will moderate through FY20 as MHJ cycles tougher comparatives, however, early sales momentum is encouraging and we lift our full year assumptions accordingly. We have lifted our SSS growth assumptions across all markets, with the largest revisions in Canada following signs of execution on productivity improvements stronger/faster than expected.

Investment View

MHJ has a new strategy and a largely new senior management team. While incremental progress is being made with its strategic priorities, it could take an extended period of time to return to its prior growth trajectory. Early signs of execution are positive, with little growth priced in, providing upside to our forecasts, however, we remain cautious given the tough nature of the retail backdrop and margin risk. **NEUTRAL**.

NZX Code	MHJ
Share price	NZ\$0.71
Target price	NZ\$0.70
Risk rating	High
Issued shares	382.5m
Market cap	NZ\$272m
Average daily turnover	443.0k (NZ\$292k)

Share Price Performance



Financials: June	19A	20E	21E	22E
NPAT* (NZ\$m)	24.3	27.9	28.7	29.9
EPS* (NZc)	6.3	7.3	7.5	7.8
EPS growth* (%)	-29.0	15.2	2.6	4.3
DPS (NZc)	4.3	5.3	5.2	5.3
Imputation (%)	100	100	80	80

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	5.2	4.9	4.8	4.6
EV/EBIT	8.2	7.1	7.0	6.8
PE	11.2	9.7	9.5	9.1
Price / NTA	1.6	1.5	1.5	n/a
Cash dividend yield (%)	6.0	7.4	7.3	7.4
Gross dividend yield (%)	8.3	10.3	9.6	9.7

*Historic and forecast numbers based on underlying profits

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Michael Hill International Ltd (MHJ)		Priced as at 11 Oct 2019: NZ\$0.71					June year end					
Forsyth Barr valuation							Valuation Ratios					
Valuation methodology		Weighted DCF and sum of the parts valuation					2018A	2019A	2020E	2021E	2022E	
12-month target price (NZ\$)*		0.70		Spot valuations (NZ\$)			EV/EBITDA (x)	4.7	5.2	4.9	4.8	4.6
Expected share price return		-1.4%	1. DCF	0.76		EV/EBIT (x)	7.1	8.2	7.1	7.0	6.8	
Net dividend yield		7.4%	2. Sum of the parts	0.62		PE (x)	7.9	11.2	9.7	9.5	9.1	
Estimated 12-month return		6.0%	3. n/a	n/a		Price/NTA (x)	1.4	1.6	1.5	1.5	1.5	
Key WACC assumptions		DCF valuation summary (NZ\$m)					Free cash flow yield (%)	12.3	9.1	1.8	9.5	9.7
Risk free rate		2.00%	Total firm value		327		Net dividend yield (%)	7.6	6.0	7.4	7.3	7.4
Equity beta		1.15	(Net debt)/cash		(26)		Gross dividend yield (%)	10.6	8.3	10.3	9.6	9.7
WACC		9.7%	Value of equity		301		Imputation (%)	100	100	100	80	80
Terminal growth		1.5%	Shares (m)		382		Pay-out ratio (%)	61	67	72	69	67
Profit and Loss Account (AUD\$m)		2018A	2019A	2020E	2021E	2022E	Capital Structure					
Sales revenue		604.0	571.1	585.2	591.0	598.9	2018A	2019A	2020E	2021E	2022E	
Normalised EBITDA		60.3	54.0	59.2	62.3	63.3	Interest cover EBIT (x)	14.9	14.0	15.3	14.8	17.4
Depreciation and amortisation		(20.2)	(19.4)	(18.6)	(20.0)	(20.2)	Interest cover EBITDA (x)	22.4	21.9	22.2	21.8	25.6
Normalised EBIT		40.1	34.6	40.7	42.3	43.1	Net debt/ND+E (%)	12.9	12.3	16.0	13.8	11.3
Net interest		(2.7)	(2.5)	(2.7)	(2.9)	(2.5)	Net debt/EBITDA (x)	0.5	0.5	0.6	0.5	0.4
Associate income		-	-	-	-	-	Key Ratios					
Tax		(5.9)	(2.3)	(11.5)	(11.9)	(12.3)	2018A	2019A	2020E	2021E	2022E	
Minority interests		-	-	-	-	-	Return on assets (%)	10.7	9.1	10.9	11.2	11.4
Normalised NPAT		31.5	22.8	26.5	27.5	28.4	Return on equity (%)	16.6	16.9	14.2	14.6	14.7
Abnormals/other		(26.9)	(6.3)	(17.5)	-	-	Return on funds employed (%)	15.8	15.7	12.9	14.3	15.1
Reported NPAT		4.6	16.5	9.0	27.5	28.4	EBITDA margin (%)	10.0	9.5	10.1	10.5	10.6
Normalised EPS (cps)		8.1	5.9	6.8	7.1	7.3	EBIT margin (%)	6.6	6.1	7.0	7.2	7.2
DPS (cps)		5.0	4.0	5.0	5.0	5.0	Capex to sales (%)	4.0	2.7	3.8	3.8	3.8
Growth Rates		2018A	2019A	2020E	2021E	2022E	Capex to depreciation (%)	119	81	121	113	112
Revenue (%)		3.8	-5.5	2.5	1.0	1.3	Operating Performance					
EBITDA (%)		-10.5	-10.4	9.8	5.1	1.6	2018A	2019A	2020E	2021E	2022E	
EBIT (%)		-15.2	-13.7	17.5	4.0	1.9	Store numbers					
Normalised NPAT (%)		-1.0	-27.5	16.2	3.8	3.1	New Zealand	52	52	52	52	52
Normalised EPS (%)		-2.1	-27.5	16.2	3.8	3.1	Australia	172	168	164	161	161
DPS (%)		0.0	-20.0	25.0	0.0	0.0	Canada	83	86	88	88	88
Cash Flow (AUD\$m)		2018A	2019A	2020E	2021E	2022E	US	0	0	0	0	0
EBITDA		60.3	54.0	59.2	62.3	63.3	Emma & Roe	6	2	0	0	0
Working capital change		3.9	(7.4)	(0.4)	(0.3)	(0.9)	Total store numbers	313	308	304	301	301
Interest & tax paid		(9.2)	(7.6)	(14.2)	(14.8)	(14.7)	Divisional revenue (A\$m)					
Other		-	-	(17.5)	-	-	New Zealand	115.4	113.0	118.5	122.4	123.4
Operating cash flow		54.9	39.0	27.2	47.2	47.6	Australia	325.7	313.6	313.9	311.9	313.6
Capital expenditure		(24.0)	(15.7)	(22.5)	(22.5)	(22.5)	Canada	133.0	140.4	151.2	155.1	160.1
(Acquisitions)/divestments		-	-	-	-	-	US	11.9	-	-	-	-
Other		-	-	-	-	-	Emma & Roe	16.9	-	-	-	-
Funding available/(required)		30.9	23.3	4.7	24.7	25.1	Other	1.1	4.1	1.6	1.7	1.8
Dividends paid		(19.4)	(19.4)	(15.5)	(19.4)	(19.4)	Total revenue	604.0	571.1	585.2	591.0	598.9
Equity raised/(returned)		-	-	-	-	-	Divisional EBIT (A\$m)					
Increase/(decrease) in net debt		(11.5)	(3.9)	10.8	(5.3)	(5.7)	New Zealand	25.6	22.7	26.3	27.4	27.9
Balance Sheet (AUD\$m)		2018A	2019A	2020E	2021E	2022E	Australia	48.6	32.9	35.1	35.0	35.2
Working capital		155.6	131.8	160.5	162.2	164.4	Canada	14.9	10.2	14.8	16.4	17.8
Fixed assets		66.7	63.2	67.2	69.7	72.0	US	(5.7)	-	-	-	-
Intangibles		12.6	15.4	15.4	15.4	15.4	Emma & Roe	(10.0)	-	-	-	-
Other assets		71.4	83.5	67.4	65.4	63.4	Unallocated	(33.3)	(31.3)	(35.5)	(36.6)	(37.7)
Total funds employed		306.3	293.9	310.5	312.7	315.3	Total EBIT	40.1	34.6	40.7	42.3	43.1
Net debt/(cash)		28.0	24.8	35.6	30.3	24.5	Divisional EBIT margins (%)					
Other non current liabilities		89.1	92.4	88.3	93.3	98.3	New Zealand	22.2	20.1	22.2	22.4	22.6
Shareholder's funds		189.2	176.8	186.7	189.2	192.5	Australia	14.9	10.5	11.2	11.2	11.2
Minority interests		-	-	-	-	-	Canada	11.2	7.3	9.8	10.6	11.1
Total funding sources		306.3	293.9	310.5	312.7	315.3	Period average exchange rates					
							AUDNZD	1.09	1.06	1.05	1.04	1.05

* Forsyth Barr target prices reflect valuation rolled forward at cost of equity less the next 12-months dividend

1Q20 — Strong start to the year

MHJ reported strong 1Q20 group same store sales (SSS) growth, up +12%, cycling weak sales growth in the prior period (1Q19 SSS -11% on 1Q18). Unsurprisingly, gross margins remain challenged given a highly competitive backdrop, which drove elevated discounting activity, particularly in Australia; although, somewhat encouragingly, showed a slight improvement on 4Q19.

Divisional insight

- **Australia (1Q20 SSS growth +6.8%):** Australia continues to be the most challenging market for MHJ, with elevated discounting activity in the sector as market share is prioritised across the competitive set. Although MHJ delivered 1H20 sales growth, it comes off the back of a -13% decline in 1Q19 (vs 1Q18). We remain cautious over the near term prospects for this market and expect further sales growth through FY20 will be tough while meaningful margin improvement is unlikely.
- **New Zealand (+10%):** Cycling a weak prior period, New Zealand delivered strong sales growth with MHJ gaining market share.
- **Canada (+16%):** Canada was the key highlight with strong sales growth following a focus on productivity improvements which included changes to its operating team, sales training, new product launched, and a new sales incentive scheme.
- **E-commerce:** 1Q20 e-commerce sales increased +18.9% year-on-year (+39.4% when adjusting for Emma & Roe). E-commerce sales are over double that of MHJ's single largest bricks & mortar store.
- **Branded collections:** Branded collections represented 38% of sales in 1Q20 (33% in FY19, 18% in FY18), illustrating continued execution on management's strategy to grow it to 50% of sales. Collections provide a superior margin profile, product refresh, and help increase store traffic.

Figure 1. MHJ sales (\$m in local currency)

Sales - local currency	2Q18	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19	1Q20	% chg vs pcq			
									2Q19	3Q19	4Q19	1Q20
Australia	112.0	67.6	76.4	66.7	106.9	65.5	72.0	68.3	-4.6%	-3.2%	-5.8%	2.3%
New Zealand	43.9	27.2	28.4	23.4	41.8	25.5	28.6	26.2	-4.8%	-6.1%	0.7%	11.8%
Canada	46.9	25.6	30.3	23.7	49.0	26.2	31.3	27.9	4.5%	2.5%	3.5%	17.6%

Source: Company reports, Forsyth Barr analysis

Earnings revisions

We have made material earnings revisions, lifting our same store sales assumptions across all markets. Canada is the key driver of the upgrades following a strong 1Q20 which illustrated execution on management's productivity initiatives. We have also trimmed gross margin assumptions marginally in FY20, reflecting the competitive backdrop.

Figure 2. Earnings changes (A\$m)

	FY20E			FY21E			FY22E		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Sales Revenue	573.8	585.2	2.0%	578.7	591.0	2.1%	585.7	598.9	2.2%
EBIT	37.0	40.7	10.0%	37.9	42.3	11.5%	38.0	43.1	13.5%
Normalised Profit	23.9	26.5	11.0%	24.4	27.5	12.9%	24.5	28.4	15.8%
Underlying EPS	6.2	6.8	11.0%	6.3	7.1	12.9%	6.3	7.3	15.8%
DPS (AUD)	5.0	5.0	-	5.0	5.0	-	5.0	5.0	-

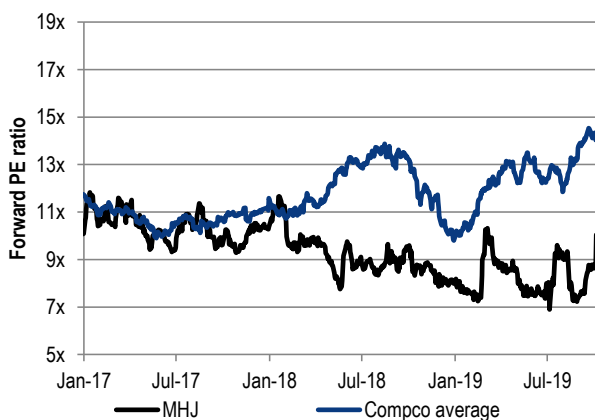
Source: Forsyth Barr analysis

Upgrade to NEUTRAL from UNDERPERFORM

We upgrade MHJ to NEUTRAL from UNDERPERFORM. Following a strong 1Q20 result with evidence of execution on productivity improvements in Canada, market share gains in all markets, and encouraging margin commentary, we have become more confident in management's new retail strategy. This has driven material earnings upgrades which, combined with a re-rating in its peer group, lifts our target price to NZ\$0.70 from NZ\$0.50.

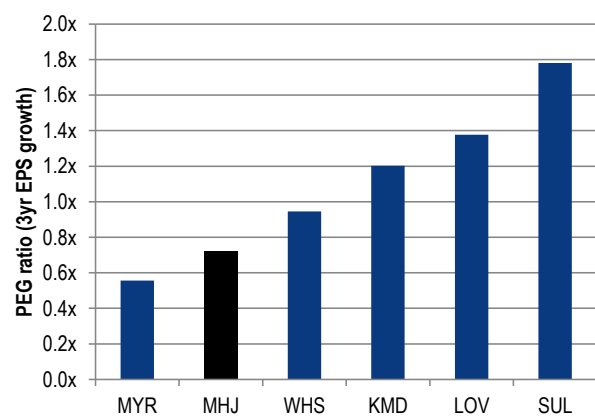
MHJ trades at a reasonable discount to peers given its growth profile, however, we believe that is fair given (1) improvements are early runs on the board and there is still plenty of water to flow under the bridge, and (2) the highly competitive and uncertain retail backdrop.

Figure 3. MHJ forward PE versus retail peers



Source: Bloomberg, Forsyth Barr analysis

Figure 4. MHJ PEG versus retail peers



Source: Bloomberg, Forsyth Barr analysis

Investment summary

Michael Hill (MHJ) recently exited its loss-making divisions (Emma & Roe and the US) and is now focussing solely on the Michael Hill brand. We are positive on this strategic directional shift; however, we are cautious given the extensive execution involved with branding and pricing strategy changes. Canadian store rollout has been revised with a medium-term target of 90 stores, and a focus on store productivity. This is materially down on prior long-term targets. We expect modest medium-to-longer term growth from its more mature NZ and Australian divisions. Our rating is NEUTRAL until we become more positive on management execution.

Earnings and cash flow outlook

- **Operating leverage:** There is significant operating leverage in the business model which can swing earnings quickly depending on top line performance. The negative impact this can have was seen in 1H19, particularly in 1Q19.
- **Same-store sales:** Following a suppressed prior period, 1Q20 same store sales rebounded strongly. However, growth is likely to moderate as it cycles tougher comps.
- **Margins:** The key opportunity is Canada from further store productivity gains. There are also efficiency opportunities in New Zealand and Australia.
- **Professional Care Plans (PCPs):** Available to add onto a purchase to cover ongoing maintenance and care. A gold mine for MHJ as payment is received upfront and margins are likely higher than its jewellery business.

Business quality

- **Largely new management team:** Previous CEO Phil Taylor stepped down for health reasons. Phil had been with MHJ for 30 years but only CEO since 2017. The new CEO is Daniel Bracken and he commenced on 15 November 2018.
- **Store rollout:** MHJ has a strong market position in Australasia, and modest near-term growth opportunities in Canada through margin improvement. MHJ will close the final six Emma & Roe stores in FY19, albeit management indicated the demi-fine category remains a possible opportunity to pursue at the right time.

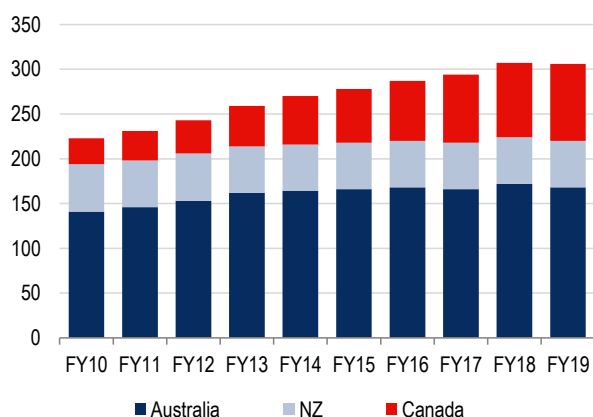
Risk Factors

- **Consumer sentiment and retail backdrop:** MHJ's products are reliant on discretionary spending. Jewellery chains that cater to the majority (e.g. MHJ) are typically less affected by economic fluctuations than luxury jewellers.
- **Competitor store closures:** The tough retail backdrop has seen competitor store footprints revised and elevated discounting activity to clear inventory. Margin risk exists as MHJ balances profitability with market share.

Company description

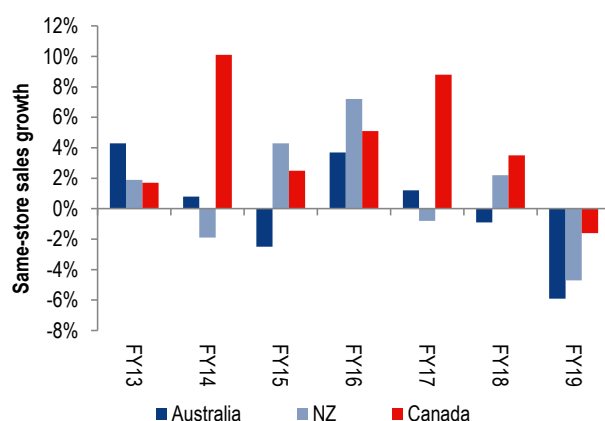
Michael Hill International operates a specialist retail jewellery chain. The company originated in Whangarei, NZ in 1979. MHJ has a large store base in Australia (171 stores) and NZ (52 stores). MHJ expanded into Canada in 2002 and is now the second largest jewellery chain by store count with 83 stores and a target to get to ~105.

Figure 5. MHJ footprint by market



Source: Forsyth Barr analysis, Company reports

Figure 6. MHJ divisional same store sales growth



Source: Forsyth Barr analysis, Company reports

Figure 7. Substantial Shareholders

Shareholder	Latest Holding
Hoglett Hamlett Limited	38.3%
ACC	6.4%
Regal Funds Mgmt	5.6%

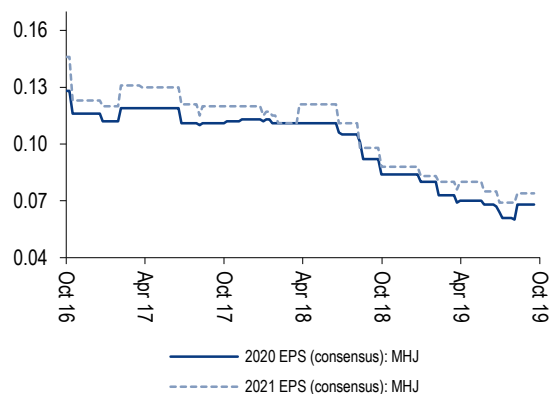
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 8. International Compcos

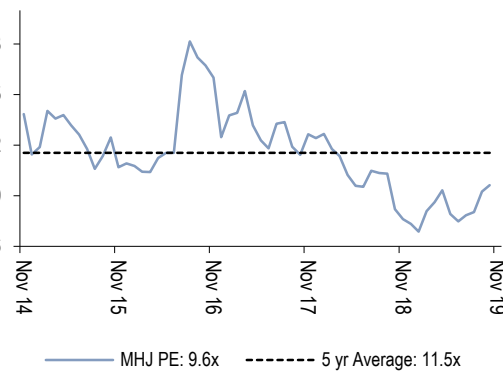
Company <i>(metrics re-weighted to reflect MHJ's balance date - June)</i>	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash D/Yld
				2020E	2021E	2020E	2021E	2020E	2021E	2021E
Michael Hill Intl	MHJ NZ	NZ\$0.71	NZ\$272	9.7x	9.5x	4.8x	4.6x	7.0x	6.8x	7.3%
Briscoe Group *	BGP NZ	NZ\$3.65	NZ\$811	12.5x	12.7x	7.7x	7.8x	8.2x	8.3x	6.1%
Kathmandu Holdings *	KMD NZ	NZ\$3.08	NZ\$698	11.4x	9.8x	5.3x	4.3x	6.4x	5.2x	6.1%
Restaurant Brands NZ *	RBD NZ	NZ\$11.85	NZ\$1,478	29.8x	26.2x	14.6x	13.5x	22.1x	20.0x	0.0%
The Warehouse Group *	WHS NZ	NZ\$2.62	NZ\$909	11.9x	10.4x	5.6x	5.0x	8.6x	7.6x	7.0%
Signet Jewelers	SIG US	US\$16.11	US\$842	5.5x	7.1x	7.4x	n/a	11.7x	n/a	10.0%
Tiffany & Co	TIF US	US\$88.07	US\$10,639	17.6x	16.3x	11.3x	10.6x	14.8x	13.8x	2.9%
Myer Holdings	MYR AT	A\$0.57	A\$468	13.2x	11.3x	3.1x	3.0x	8.5x	7.5x	2.7%
Lovisa Holdings	LOV AT	A\$12.54	A\$1,326	32.0x	25.2x	17.9x	14.1x	21.8x	17.1x	3.2%
Compcos Average:				16.7x	14.9x	9.1x	8.3x	12.8x	11.4x	4.8%
MHJ Relative:				-42%	-36%	-48%	-45%	-46%	-40%	+54%

EV = Current Market Cap + Actual Net Debt

Source: *Forsyth Barr analysis, Bloomberg Consensus, Compcos metrics re-weighted to reflect headline (MHJ) companies fiscal year end

Figure 9. Consensus EPS Momentum


Source: Forsyth Barr analysis, Bloomberg

Figure 10. 12 Month Forward PE


Source: Forsyth Barr analysis

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