

Michael Hill Intl

Sales Glimmer, Margin Dimmer — 1H20 Preview

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NEUTRAL 

Michael Hill (MHJ) achieved robust sales through the key Christmas period, however, margins remain under pressure given the tough competitive backdrop in combination with gold price headwinds. MHJ will report its 1H20 result on Wednesday, 26 February. We expect to see earnings growth off a low base; however, sales growth continues to come at the expense of margins. Commentary on the medium-term strategic priorities and the margin outlook will be of interest to investors.

NZX Code	MHJ	Financials: Jun/	19A	20E	21E	22E	Valuation (x)	19A	20E	21E	22E
Share price	NZ\$0.66	NPAT* (NZ\$m)	24.3	27.0	27.5	29.3	EV/EBITDA	4.9	4.7	4.6	4.4
Target price	NZ\$0.70	EPS* (NZc)	6.3	7.1	7.2	7.7	EV/EBIT	7.6	6.9	6.9	6.5
Risk rating	High	EPS growth* (%)	-29.0	11.3	2.0	6.5	PE	10.4	9.4	9.2	8.6
Issued shares	382.5m	DPS (NZc)	4.3	5.3	5.2	5.3	Price / NTA	1.5	1.4	1.4	1.4
Market cap	NZ\$252m	Imputation (%)	100	100	80	80	Cash div yld (%)	6.4	8.0	7.9	8.0
Avg daily turnover	375.4k (NZ\$250k)	*Based on normalised profits					Gross div yld (%)	8.9	11.1	10.3	10.5

2Q20 — Robust sales outweighed by margins which remain suppressed

MHJ reported 2Q20 sales growth ahead of our expectations (same store sales up +4.0%) as the company continues to cycle weak prior periods. New Zealand was a highlight, achieving robust quarterly sales growth (up +5.4%). Disappointingly, gross margins remain suppressed amid a challenging competitive backdrop (particularly in Australia) and increasing costs, with commentary suggesting there has been no improvement in recent quarters. We have lowered our FY20E earnings estimates (underlying NPAT lowered -3.4% to NZ\$26.1m) reflecting a reduction in our gross margin assumption, as well as minor negative revisions to our medium term forecasts.

Key points of interest at 1H20 result

- **Margin commentary:** Our forecasts assume a steady improvement in margins. With competitor discounting remaining prevalent, cost management is important. MHJ has indicated it expects to benefit from improved working capital management and other operating efficiencies.
- **Canada:** Canada has been highlighted as a key focus and opportunity for MHJ, with a number of initiatives undertaken to lift productivity. Evidence of execution would be encouraging for the broader strategy.
- **Coronavirus impacts:** Product sourcing predominantly occurs in India, which, combined with the slow stock turn nature of jewellery, limits any impact on supply chain. However, a reduction in Chinese tourism is likely to have a flow through into demand.

MHJ will host a conference call at 12:30pm NZT (9:30am AEST). Dial in details are 0800 667 018 for New Zealand (1800 148 258 for Australia); conference ID is 3298201.

Figure 1. 1H20E result expectations (A\$m)

	1H19	1H20E	% change
Revenue	315.4	328.2	4.0%
EBIT	28.5	33.0	15.6%
Normalised NPAT	19.5	22.1	12.9%
EPS (cps)	5.0	5.7	12.9%
DPS (cps)	2.5	2.5	-

Source: Company reports, Forsyth Barr analysis

Figure 2. EBIT breakdown (A\$m)

	1H19	1H20E	% change
New Zealand	14.1	15.5	10.3%
Australia	24.6	24.4	-0.9%
Canada	8.9	10.9	22.1%
Corporate	(19.1)	(17.8)	-6.9%
Total EBIT	28.5	33.0	15.6%

Source: Company reports, Forsyth Barr analysis

Michael Hill International Ltd (MHJ)

Priced as at 20 Feb 2020 (NZ\$)					0.66						
12-month target price (NZ\$)*					0.70	Spot valuations (NZ\$)					
Expected share price return					6.1%	1. DCF					0.72
Net dividend yield					2.4%	2. Sum of the parts					0.62
Estimated 12-month return					8.5%	3. n/a					n/a
Key WACC assumptions						DCF valuation summary (NZ\$m)					
Risk free rate					2.00%	Total firm value					311
Equity beta					1.15	(Net debt)/cash					(26)
WACC					9.8%	Less: Capitalised operating leases					
Terminal growth					1.5%	Value of equity					285
Profit and Loss Account (NZ\$m)	2018A	2019A	2020E	2021E	2022E	Valuation Ratios	2018A	2019A	2020E	2021E	2022E
Sales revenue	604.0	571.1	589.0	594.9	602.8	EV/EBITDA (x)	7.7	7.5	7.9	7.8	7.7
Normalised EBITDA	60.3	54.0	58.0	60.9	62.7	EV/EBIT (x)	n/a	n/a	n/a	n/a	n/a
Depreciation and amortisation	(20.2)	(19.4)	(18.6)	(20.0)	(20.2)	PE (x)	n/a	n/a	n/a	n/a	n/a
Normalised EBIT	40.1	34.6	39.5	40.9	42.5	Price/NTA (x)	0.0	0.0	0.0	0.0	0.0
Net interest	(2.7)	(2.5)	(2.7)	(3.0)	(2.7)	Free cash flow yield (%)	12.2	9.2	1.1	9.3	9.7
Associate income	0	0	0	0	0	Net dividend yield (%)	2.4	2.3	2.7	2.3	2.3
Tax	(5.9)	(2.3)	(11.1)	(11.4)	(12.0)	Gross dividend yield (%)	2.4	2.3	2.7	2.3	2.3
Minority interests	0	0	0	0	0						
Normalised NPAT	31.5	22.8	25.6	26.4	27.8	Capital Structure	2018A	2019A	2020E	2021E	2022E
Abnormals/other	(26.9)	(6.3)	(17.5)	0	0	Interest cover EBIT (x)	0.2	0.2	0.1	0.1	0.1
Reported NPAT	4.6	16.5	8.1	26.4	27.8	Interest cover EBITDA (x)	0.1	0.1	0.1	0.1	0.1
Normalised EPS (cps)	8.1	5.9	6.6	6.8	7.2	Net debt/ND+E (%)	100.0	100.0	100.0	100.0	100.0
DPS (cps)	5.0	4.0	5.0	5.0	5.0	Net debt/EBITDA (x)	9.4	9.1	10.0	9.4	9.4
Growth Rates	2018A	2019A	2020A	2021A	2022A	Key Ratios	2018A	2019A	2020E	2021E	2022E
Revenue (%)	3.8	-5.5	3.1	1.0	1.3	Return on assets (%)	10.7	9.1	10.5	10.8	11.2
EBITDA (%)	-10.5	-10.4	7.5	4.9	3.0	Return on equity (%)	16.6	16.9	13.8	14.1	14.7
EBIT (%)	-15.2	-13.7	14.0	3.7	4.0	Return on funds employed (%)	15.8	15.7	12.5	13.9	14.9
Normalised NPAT (%)	-1.0	-27.5	12.2	3.2	5.3	EBITDA margin (%)	10.0	9.5	9.9	10.2	10.4
Normalised EPS (%)	-2.1	-27.5	12.2	3.2	5.3	EBIT margin (%)	6.6	6.1	6.7	6.9	7.1
Ordinary DPS (%)	0.0	-20.0	25.0	0.0	0.0	Capex to sales (%)	4.0	2.7	3.8	3.8	3.7
						Capex to depreciation (%)	119	81	121	113	112
						Imputation (%)	100	100	100	80	80
						Pay-out ratio (%)	n/a	n/a	n/a	n/a	n/a
Cash Flow (NZ\$m)	2018A	2019A	2020E	2021E	2022E	Operating Performance	2018A	2019A	2020E	2021E	2022E
EBITDA	60.3	54.0	58.0	60.9	62.7	Divisional revenue (A\$m)					
Working capital change	3.9	(7.4)	(1.4)	(0.4)	(0.9)	New Zealand	115.4	113.0	120.8	124.7	125.7
Interest & tax paid	(9.2)	(7.6)	(13.8)	(14.5)	(14.7)	Australia	325.7	313.6	315.4	313.4	315.1
Other	0	0	(17.5)	0	0	Canada	133.0	140.4	151.2	155.1	160.1
Operating cash flow	54.9	39.0	25.2	46.1	47.1	Other	29.9	4.1	1.6	1.7	1.8
Capital expenditure	(24.0)	(15.7)	(22.5)	(22.5)	(22.5)	Total revenue	604.0	571.1	589.0	594.9	602.8
(Acquisitions)/divestments	0	0	0	0	0						
Other	0	0	0	0	0	Divisional EBIT (A\$m)					
Funding available/(required)	30.9	23.3	2.7	23.6	24.6	New Zealand	25.6	22.7	26.3	28.1	29.0
Dividends paid	(19.4)	(19.4)	(15.5)	(19.4)	(19.4)	Australia	48.6	32.9	34.1	33.0	33.4
Equity raised/(returned)	0	0	0	0	0	Canada	14.9	10.2	14.5	16.4	17.8
(Increase)/decrease in net debt	11.5	3.9	(12.8)	4.2	5.2	Corporate and other	(49.0)	(31.3)	(35.5)	(36.6)	(37.7)
						Total EBIT	40.1	34.6	39.5	40.9	42.5
Balance Sheet (NZ\$m)	2018A	2019A	2020E	2021E	2022E	Store numbers					
Working capital	155.6	131.8	161.6	163.3	165.5	New Zealand	52	52	52	52	52
Fixed assets	66.7	63.2	67.2	69.7	72.0	Australia	172	168	164	161	161
Intangibles	12.6	15.4	15.4	15.4	15.4	Canada	83	86	88	88	88
Right of use asset	0	0	0	0	0						
Other assets	71.4	83.5	67.4	65.4	63.4						
Total funds employed	306.3	293.9	311.6	313.8	316.4						
Net debt/(cash)	28.0	24.8	37.5	33.4	28.2						
Lease liability	0	0	0	0	0						
Other liabilities	89.1	92.4	88.3	93.3	98.4						
Shareholder's funds	189.2	176.8	185.7	187.1	189.8						
Minority interests	0	0	0	0	0						
Total funding sources	306.3	293.9	311.6	313.8	316.4						

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

2Q20 – Margins suppressed

MHJ reported robust 2Q20 group same store sales (SSS) growth, up +4.0% (+6.5% for 1H20) and marginally ahead of expectations. Sales growth continues to come at the expense of gross margins with commentary suggesting margins remain in line with recent quarters and materially behind our prior expectations.

Divisional insight

- **Australia (2Q20 SSS growth +1.6%):** Australia remains a challenging market for MHJ, with elevated discounting activity in the sector as market share is prioritised across the competitive set. SSS growth for 1H20 of +3.4% was ahead of our expectations and prior full year run-rate (+2.5%), however, we expect this has been at the expense of gross margin.
- **New Zealand (+5.0%):** Delivered a second period of strong SSS growth (albeit cycling weak prior periods) and was the standout market in 2Q20. 1H20 SSS growth of +6.7% was ahead of both our expectations and prior full year run-rate (+4.0%).
- **Canada (+1.4%):** SSS slowed as it cycled a tougher comparable. 1H20 SSS growth of +5.4% was largely in line with expectations as the company looks to extract productivity gains in the underperforming market.
- **E-commerce:** Online continues to grow with 2Q20 e-commerce sales up +47% year-on-year, now representing 3.3% of group sales. MHJ launched its loyalty programme online during the period; take up rates are encouraging although we note it is early days.
- **Branded collections:** Branded collections, which are higher margin products, represented 35.4% of sales in 1H20. This is somewhat disappointing as it implies a reduction in 2Q20 (1Q20 branded collections 38%). MHJ is launching three new bridal collections in 2H20E, which should help drive sales penetration of branded collections.

Figure 3. MHJ sales (\$m local currency)

	3Q18	4Q18	1Q19	2Q19	3Q19	4Q19	1Q20	2Q20	% change vs pcg			
									3Q19	4Q19	1Q20	2Q20
Australia	67.6	76.4	66.7	106.9	65.5	72.0	68.3	105.9	-3.2%	-5.8%	2.3%	-0.9%
New Zealand	27.2	28.4	23.4	41.6	25.5	28.6	26.2	43.9	-6.1%	0.7%	11.8%	5.4%
Canada	25.6	30.3	23.7	48.7	26.2	31.3	27.9	50.5	2.5%	3.5%	17.6%	3.7%
Total (AUD)	118.5	133.7	113.0	197.1	117.6	132.6	124.0	203.5	-0.8%	-0.8%	9.7%	3.3%

Source: Company reports, Forsyth Barr analysis

Earnings revisions

We have made minor negative revisions to our forecasts on the back of 2Q20 sales. We have lifted our sales assumptions in FY20E following better than expected 1H20 sales, however, commentary suggesting gross margins remain suppressed has seen us reduce our gross margin assumption, more than offsetting revenue changes. At this stage, we have left our dividend assumption flat. Changes over the medium term reflect a slower recovery of gross margin.

Figure 4. Earnings changes (A\$m)

	2020E			2021E			2022E		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Sales Revenue	585.2	589.0	0.7%	591.0	594.9	0.7%	598.9	602.8	0.7%
EBIT	40.7	39.5	-3.0%	42.3	40.9	-3.3%	43.1	42.5	-1.3%
Normalised Profit	26.5	25.6	-3.4%	27.5	26.4	-3.9%	28.4	27.8	-1.9%
Underlying EPS	6.8	6.6	-3.4%	7.1	6.8	-3.9%	7.3	7.2	-1.9%
DPS (AUD)	5.0	5.0	-	5.0	5.0	-	5.0	5.0	-

Source: 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.

Business quality

- **Improving brand:** Growth in branded collections sales indicates improving brand strength and an opportunity to drive foot traffic in off peak times.
- **Market position:** MHJ has a strong market position in Australasia, and modest near-term growth opportunities in Canada through productivity improvement.

Earnings and cashflow 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.
- **Same-store sales:** Following a suppressed prior period, 1H20 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.

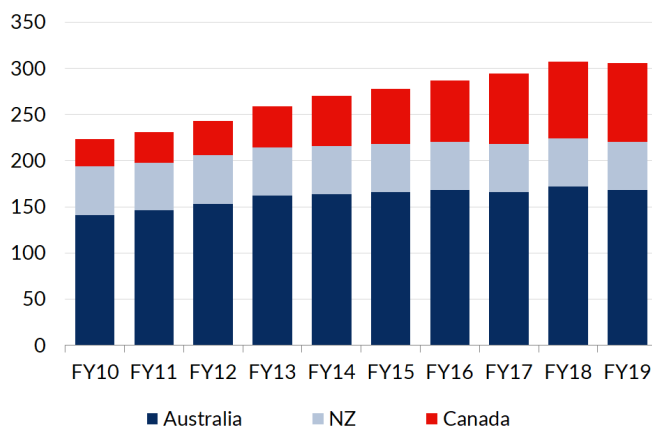
Financial structure

- **Gearing:** MHJ has reduced its debt levels in recent years as it exited underperforming businesses. The balance sheet ~12% geared.

Risk factors

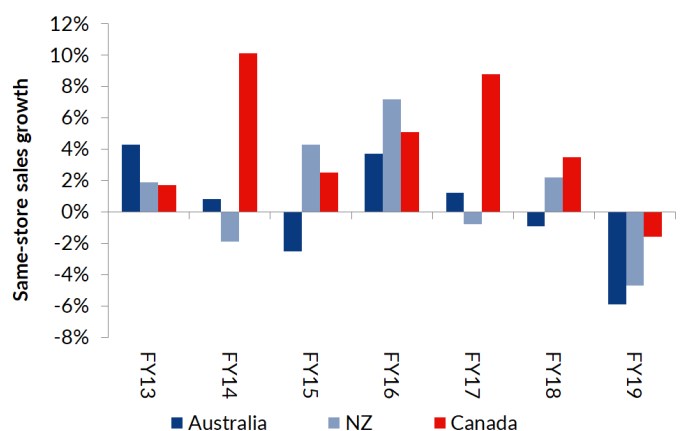
- **Consumer sentiment and retail backdrop:** MHJ's products are reliant on discretionary spending. Jewellery chains that cater to the majority (e.g. MHJ) are typically less affected by economic fluctuations than luxury jewellers.
- **Competitor store closures:** The tough retail backdrop has seen competitor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

Figure 5. MHJ footprint by market

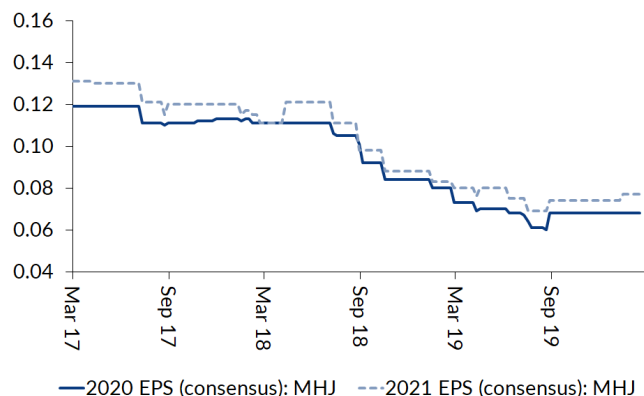


Source: Company reports, Forsyth Barr analysis

Figure 6. MHJ divisional same store sales growth



Source: Company reports, Forsyth Barr analysis

Figure 7. Price Performance


Source: Forsyth Barr analysis

Figure 8. Substantial Shareholders

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

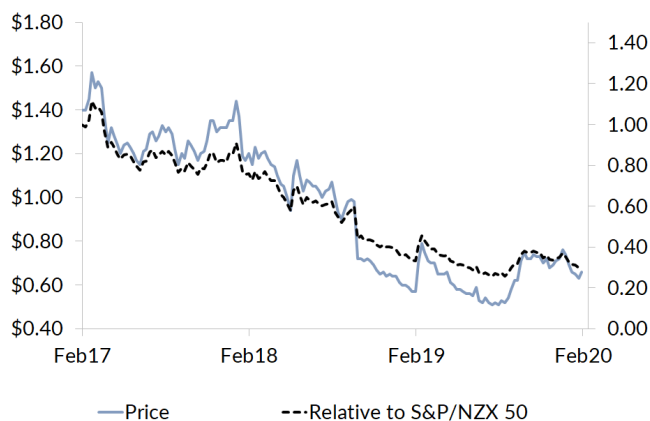
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 9. International valuation comparisons

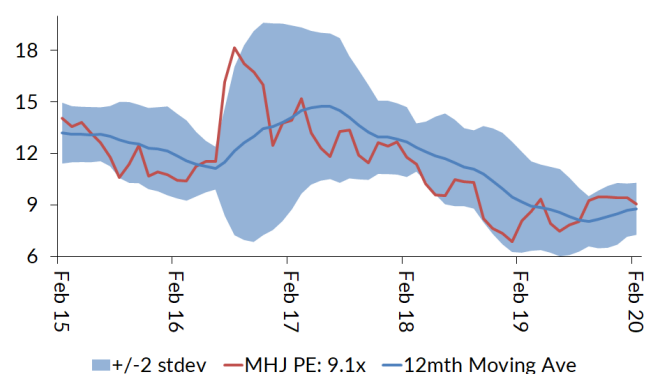
Company	Code	Price	Mkt Cap (m)	PE 2020E	PE 2021E	EV/EBITDA 2020E	EV/EBITDA 2021E	EV/EBIT 2020E	EV/EBIT 2021E	Cash Yld 2021E
(metrics re-weighted to reflect MHJ's balance date - June)										
Michael Hill Intl	MHJ NZ	NZ\$0.66	NZ\$252	9.4x	9.2x	4.6x	4.4x	6.7x	6.5x	7.9%
Briscoe Group *	BGP NZ	NZ\$3.99	NZ\$887	14.1x	13.8x	8.7x	8.6x	9.3x	9.2x	5.6%
Kathmandu Holdings *	KMD NZ	NZ\$3.55	NZ\$1,048	13.2x	11.4x	7.9x	6.4x	9.6x	7.7x	5.3%
Restaurant Brands NZ *	RBD NZ	NZ\$12.85	NZ\$1,603	36.4x	31.8x	17.2x	15.6x	26.5x	23.8x	0.0%
The Warehouse Group *	WHS NZ	NZ\$2.69	NZ\$933	12.2x	10.7x	5.7x	5.1x	8.8x	7.8x	6.8%
Signet Jewelers	SIG US	US\$27.30	US\$1,427	7.6x	8.0x	8.1x	8.4x	12.2x	n/a	5.9%
Tiffany & Co	TIF US	US\$134.26	US\$16,263	28.5x	26.7x	17.3x	16.4x	22.7x	21.6x	1.9%
Myer Holdings	MYR AT	A\$0.39	A\$320	9.2x	8.0x	2.2x	2.1x	6.2x	5.4x	3.1%
Lovisa Holdings	LOV AT	A\$11.30	A\$1,195	31.4x	25.0x	18.6x	14.8x	23.5x	18.7x	3.4%
Compco Average:				19.1x	16.9x	10.7x	9.7x	14.8x	13.5x	4.0%
MHJ Relative:				-51%	-46%	-57%	-55%	-55%	-51%	97%

EV = Current Market Cap + Actual Net Debt

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

Figure 10. Consensus EPS momentum


Source: Forsyth Barr analysis

Figure 11. 12 Month Forward PE


Source: Forsyth Barr analysis

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