FORSYTH BARR

NEW ZEALAND EQUITY RESEARCH | RETAIL | JEWELLERY RETAILER

27 FEBRUARY 2020

Michael Hill Intl
1H20 Result — Needs a Polish

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NEUTRAL

Michael Hill International (MHJ) reported a softer than expected 1H20 result, underpinned by margin contraction. The company has signalled it expects 1H20 represents a gross margin trough, as it looks to advance a number of sales initiatives and supply chain efficiencies to expand margins. Heading into the second half, MHJ is cycling a period of stronger sales against a backdrop of weaker margins. Whilst corporate cost-out is encouraging and growth in market share is a longer term positive, we remain cautious over the rate of margin improvement. We see the current risk/reward as balanced and retain our NEUTRAL rating.

NZX Code	MHJ
Share price	NZ$0.60
Target price	NZ$0.65
Risk rating	High
Issued shares	382.5m
Market cap	NZ$229m
Avg daily turnover	379.3k (NZ$253k)

Financials: Jun/	19A	20E	21E	22E
NPAT* (NZ$m)	24.3	25.8	26.1	27.6
EPS* (NZc)	6.3	6.8	6.8	7.2
EPS growth* (%)	-29.0	6.6	0.9	5.7
DPS (NZc)	4.3	3.2	5.2	5.3
Imputation (%)	100	100	80	80
*Based on normalised profits				

Valuation (x)	19A	20E	21E	22E
EV/EBITDA	4.5	4.4	4.4	4.3
EV/EBIT	7.0	6.6	6.7	6.4
PE	9.5	8.9	8.8	8.3
Price / NTA	1.3	1.3	1.3	1.3
Cash div yld (%)	7.1	5.3	8.7	8.8
Gross div yld (%)	9.8	7.3	11.4	11.5

1H20 — Sales glimmer, margins dimmer

The challenging retail backdrop persisted through 1H20, with elevated discounting activity combined with cost headwinds weighing on group gross margin. Store gross margin contracted to 59.1% (from 62.5% in 1H19). Providing some margin offset was delivery on corporate cost-out initiatives, with MHJ reporting underlying group EBIT of A$31.6m, up +6.6% as it cycled a weak prior period. Encouragingly, sales momentum continued with group same store sales up +6.3% in 1H20, led by strong growth in New Zealand and Canada, as the brand gained market share across all geographies.

Strategy update: A more refined approach

MHJ has reached a turning point, refining its strategy towards gross profit dollar. During FY19, MHJ moved to target market share gains at the expense of margins, which delivered positive sales momentum. Gross margins are now at recent lows across all three markets, with MHJ expecting an improvement to come from a mix of (1) sales incentive schemes, (2) improved product sales mix, (3) supply chain efficiencies, and (4) an ongoing reduction in overheads.

Outlook and earnings changes

MHJ provided no formal guidance, although identified the challenging retail backdrop in and recent macro-events (such as cornoavirus) as creating additional near-term uncertainty. We view a growing focus on gross margin dollar as a positive and forecast incremental improvements in margins over the medium-term. However, we have made modest cuts to our earnings (FY20E/21E/22E EBIT down ~-4%), which reflect a lower base margin assumption and a slower path to improvement. Although we forecast incremental improvement in margins alongside low single digit same store sales growth, we remain cautious of any detrimental impact to sales, in light of indications of a decline in sales in the wider jewellery category.

MHJ cut its interim dividend -1.0cps (AUD) to 1.5cps, in light of its previously highlighted wage remediation costs. Wage remediation costs are now expected to be towards the top end of the previous announced range (A$10m to A$25m), and as such we have lifted our expectations to A$22m. This cost is expected to be a one off occurring in 2H20.

FORSYTH BARR

Michael Hill International Ltd (MHJ)

Priced as at 26 Feb 2020 (NZ$)	0.60

12-month target price (NZ$)*	**0.65**
Expected share price return	8.3%
Net dividend yield	2.6%
Estimated 12-month return	10.9%

Key WACC assumptions	
Risk free rate	2.00%
Equity beta	1.15
WACC	9.8%
Terminal growth	1.5%

Profit and Loss Account (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Sales revenue	604.0	571.1	585.5	591.3	597.8
Normalised EBITDA	**60.3**	**54.0**	**56.5**	**59.2**	**60.7**
Depreciation and amortisation	(20.2)	(19.4)	(18.6)	(20.0)	(20.2)
Normalised EBIT	**40.1**	**34.6**	**38.0**	**39.2**	**40.6**
Net interest	(2.7)	(2.5)	(2.9)	(3.4)	(3.2)
Associate income	0	0	0	0	0
Tax	(5.9)	(2.3)	(10.5)	(10.7)	(11.2)
Minority interests	0	0	0	0	0
Normalised NPAT	**31.5**	**22.8**	**24.5**	**25.1**	**26.2**
Abnormals/other	(26.9)	(6.3)	(22.0)	0	0
Reported NPAT	**4.6**	**16.5**	**2.5**	**25.1**	**26.2**
Normalised EPS (cps)	8.1	5.9	6.3	6.5	6.8
DPS (cps)	5.0	4.0	3.0	5.0	5.0

Growth Rates	**2018A**	**2019A**	**2020A**	**2021A**	**2022A**
Revenue (%)	3.8	-5.5	2.5	1.0	1.1
EBITDA (%)	-10.5	-10.4	4.7	4.6	2.6
EBIT (%)	-15.2	-13.7	9.7	3.2	3.5
Normalised NPAT (%)	-1.0	-27.5	7.5	2.2	4.5
Normalised EPS (%)	-2.1	-27.5	7.5	2.2	4.5
Ordinary DPS (%)	0.0	-20.0	-25.0	66.7	0.0

Cash Flow (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EBITDA	**60.3**	**54.0**	**56.5**	**59.2**	**60.7**
Working capital change	3.9	(7.4)	(0.4)	(0.3)	(0.5)
Interest & tax paid	(9.2)	(7.6)	(13.4)	(14.1)	(14.4)
Other	0	0	(22.0)	0	0
Operating cash flow	**54.9**	**39.0**	**20.7**	**44.7**	**45.8**
Capital expenditure	(24.0)	(15.7)	(22.5)	(22.5)	(22.5)
(Acquisitions)/divestments	0	0	0	0	0
Other	0	0	0	0	0
Funding available/(required)	**30.9**	**23.3**	**(1.8)**	**22.2**	**23.3**
Dividends paid	(19.4)	(19.4)	(15.5)	(19.4)	(19.4)
Equity raised/(returned)	0	0	0	0	0
(Increase)/decrease in net debt	**11.5**	**3.9**	**(17.3)**	**2.8**	**3.9**

Balance Sheet (NZ$m)	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Working capital	155.6	131.8	160.6	162.2	164.1
Fixed assets	66.7	63.2	67.2	69.7	72.0
Intangibles	12.6	15.4	15.4	15.4	15.4
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**	**310.6**	**312.8**	**315.0**
Net debt/(cash)	28.0	24.8	42.1	39.3	35.4
Lease liability	0	0	0	0	0
Other liabilities	89.1	92.4	88.3	93.3	98.3
Shareholder's funds	189.2	176.8	180.2	180.2	181.3
Minority interests	0	0	0	0	0
Total funding sources	**306.3**	**293.9**	**310.6**	**312.8**	**315.0**

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

Spot valuations (NZ$)	
1. DCF	0.71
2. Sum of the parts	0.61
3. n/a	n/a

DCF valuation summary (NZ$m)	
Total firm value	307
(Net debt)/cash	(26)
Less: Capitalised operating leases	
Value of equity	281

Valuation Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
EV/EBITDA (x)	6.5	6.3	6.6	6.4	6.3
EV/EBIT (x)	n/a	n/a	n/a	n/a	n/a
PE (x)	n/a	n/a	n/a	n/a	n/a
Price/NTA (x)	0.0	0.0	0.0	0.0	0.0
Free cash flow yield (%)	13.5	10.1	-0.8	9.7	10.2
Net dividend yield (%)	2.7	2.5	2.5	2.6	2.6
Gross dividend yield (%)	2.7	2.5	2.5	2.6	2.6

Capital Structure	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Interest cover EBIT (x)	0.2	0.2	0.1	0.1	0.1
Interest cover EBITDA (x)	0.1	0.1	0.1	0.1	0.1
Net debt/ND+E (%)	100.0	100.0	100.0	100.0	100.0
Net debt/EBITDA (x)	9.4	9.1	9.7	9.0	9.0

Key Ratios	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Return on assets (%)	10.7	9.1	10.2	10.4	10.7
Return on equity (%)	16.6	16.9	13.6	13.9	14.4
Return on funds employed (%)	15.8	15.7	12.2	13.5	14.5
EBITDA margin (%)	10.0	9.5	9.7	10.0	10.2
EBIT margin (%)	6.6	6.1	6.5	6.6	6.8
Capex to sales (%)	4.0	2.7	3.8	3.8	3.8
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

Operating Performance	**2018A**	**2019A**	**2020E**	**2021E**	**2022E**
Divisional revenue (A$m)					
New Zealand	115.4	113.0	119.7	123.5	123.9
Australia	325.7	313.6	314.5	312.5	314.2
Canada	133.0	140.4	149.7	153.6	157.8
Other	29.9	4.1	1.6	1.7	1.8
Total revenue	**604.0**	**571.1**	**585.5**	**591.3**	**597.8**
Divisional EBIT (A$m)					
New Zealand	25.6	22.7	24.3	26.7	27.3
Australia	48.6	32.9	30.7	28.7	29.7
Canada	14.9	10.2	10.9	13.2	14.4
Corporate and other	(49.0)	(31.3)	(28.0)	(29.4)	(30.9)
Total EBIT	**40.1**	**34.6**	**38.0**	**39.2**	**40.6**
Store numbers					
New Zealand	52	52	52	52	52
Australia	172	168	164	161	161
Canada	83	86	88	88	88

1H20 result summary

1H20 can be characterised by gross margin compression as a combination of elevated discounting activity and cost headwinds weighed on the result. MHJ reported 1H20 underlying EBIT of A$31.6m, with a miss across all markets. Brand gross margin fell to 59.1% from 62.5%. Encouragingly, corporate cost-out is delivering results, with head office costs ~-A$4.5m lower than the prior comparable period, with cost-out initiatives ongoing.

MHJ declared an interim dividend of 1.5cps in AUD, well behind expectations (FB 2.5cps). This is a function of MHJ's previously announced wage remediation payments being higher than expected (FB A$22m).

Figure 1. Result summary (A$m)

	1H19	1H20	% chg	Forsyth Barr
Sales revenue	315.4	329.5	4.5%	328.2
Gross profit	197.1	194.8	-1.2%	203.8
Gross margin (store)	62.5%	59.1%	-3.4pp	62.1%
EBIT	**29.6**	**31.6**	**6.8%**	**33.0**
Reported profit	17.9	21.4	19.6%	22.1
Normalised profit	**19.5**	**21.6**	**10.8%**	**22.1**
Underlying EPS (cps)	5.0	5.5	10.0%	5.7
DPS (AUD, cps)	2.5	1.5	-40.0%	2.5

Source: Company reports, Forsyth Barr analysis

Earnings revisions

We have made modest cuts to our medium term earnings forecasts, reflecting lower gross margin assumptions across all markets. We assume a modest improvement in gross margin over the medium term as MHJ targets improved sales strategies, supply chain efficiencies, and product sales mix. Although we note that the retail environment remains challenging in the near-term with consumer confidence remaining subdued and uncertainty surrounding coronavirus. All earnings changes are made on a pre-IFRS 16 basis.

Figure 2. Earnings changes (A$m)

	FY20E			FY21E			FY22E		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Sales Revenue	589.0	585.5	-0.6%	594.9	591.3	-0.6%	602.8	597.8	-0.8%
EBIT	39.5	38.0	-3.8%	40.9	39.2	-4.2%	42.5	40.6	-4.7%
Normalised Profit	**25.6**	**24.5**	**-4.2%**	**26.4**	**25.1**	**-5.2%**	**27.8**	**26.2**	**-5.9%**
Underlying EPS	6.6	6.3	-4.2%	6.8	6.5	-5.2%	7.2	6.8	-5.9%
DPS (AUD)	5.0	3.0	-40.0%	5.0	5.0	-	5.0	5.0	-

Source: Forsyth Barr analysis

Target price lowered to NZ$0.65; NEUTRAL

Our target price falls -5cps (-7%) to NZ$0.65, primarily driven by earnings changes. We retain our NEUTRAL rating as see the risk reward as balanced. MHJ is at a critical point in its retail strategy as it looks to move away from prioritising market share and begin to focus on margins and gross profit. Whilst we have a positive view on the updated strategy, we see the risk/reward as balanced given (1) challenges in lifting margin without impacting sales, and (2) a difficult retail environment.

Key result take outs

Divisional insights

Australia — EBIT down -8.0%

Australia remains a tough market for MHJ with ongoing discounting activity. However, same store sales (SSS) growth of +3.3% indicates market share gains against a category which saw sales decline over the same period. Although market share gains are positive, we view the scope for margin improvements over the medium-term cautiously. 1H20 gross margin of 59.9% was behind expectations and materially down on the prior period. (1H19 63.0%). One store was closed during the period, with a couple more closures on the cards in the second half.

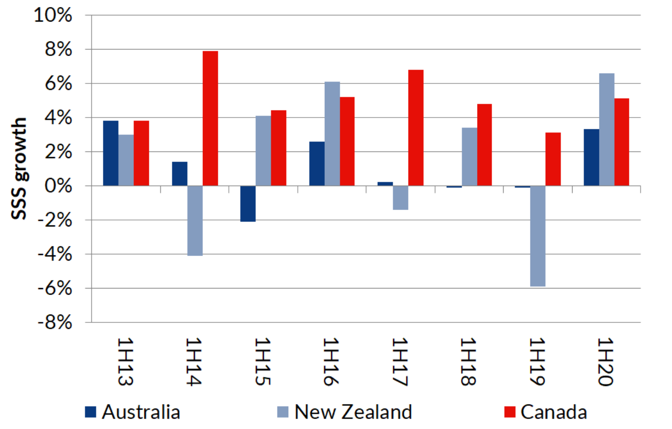
New Zealand — EBIT down -2.5%

New Zealand was a key disappointment relative to our forecasts, despite strong SSS growth (up +6.6%), with the largest decline in gross margin (1H20 58.8% vs. 1H19 62.7%). Management highlights a combination of cost headwinds and a function of sales mix (higher portion of low margin, high value sales) in 1H20 as driving the margin miss. The store portfolio is expected to be held flat during FY20E.

Canada — EBIT down -1.4%

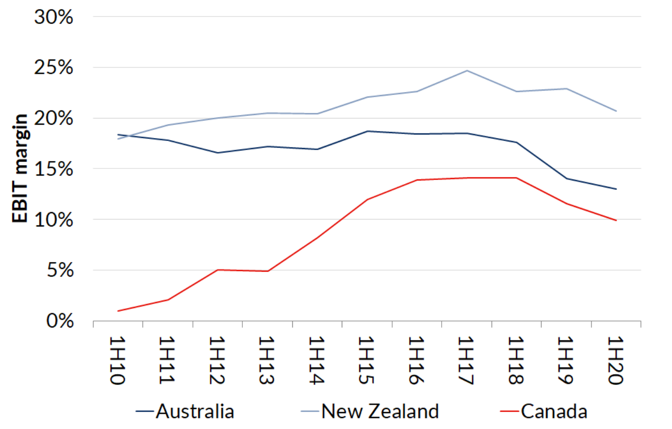
Canada is a key focus for MHJ and represents an opportunity for earnings growth. Improvements in store productivity are evident in 1H20 and are encouraging signs of execution on targets; however, similar to other markets, margin contraction was a feature with gross margin falling to 58.2% (1H19 61.8%). SSS growth remained robust during the period, up +5.1%. One new store was opened in Canada during the period, with no additional stores expected in the second half.

Figure 3. Same store sales (SSS) growth



Source: Company reports, Forsyth Barr analysis

Figure 4. EBIT margin



Source: Company reports, Forsyth Barr analysis

Turning point in strategy — Focus turns to balancing margin and sales

MHJ has signalled its intention to reduce its focus on market share and have a more balanced approach to gross profit dollar going forward. Following management changes in 2Q19, a refined strategy saw top line recovery targeted at the expense of margins, with sales momentum improving throughout the year. The company is now at an inflection point as it looks to begin lifting margins. We are supportive of the strategy and expect steady improvement in margins over the medium term, although remain cautious at this early stage.

Margin strategies

- **Sales incentive scheme:** MHJ has begun to roll out a new sales incentive scheme, which was in ~100 stores through 2Q20. Across those stores, the average gross margin achieved is +100bp ahead of stores without the scheme. MHJ plan to roll it out across the remainder of the portfolio through 2H20.
- **Supply chain efficiencies:** Negotiating improved terms with vendors and better inventory management are expected to unlock gains.
- **Branded collections:** Sales of higher margin branded collections represented 35.4% of total sales in 1H20 (32.5% in FY19). MHJ has a target of 50%.

In addition to company led initiatives, MHJ may benefit from a reversal of cost headwinds. The combination of both FX and gold headwinds had a negative -300bp impact on gross margin in 1H20.

1H20 result breakdown

Figure 5. 1H20 result breakdown (A$m)

	1H19	1H20	% chg	Comment
Profit and loss account				
Sales Revenue	**315.4**	**329.5**	**4.4%**	**1H20 SSS +6.3% on the prior period**
Cost of Sales	(113.0)	(126.0)	11.6%	
Gross Profit	**202.5**	**203.4**	**0.5%**	**Store gross margin contrction (1H20 62.5% vs 1H19 59.1%)**
SG&A Costs	(164.3)	(162.3)	-1.2%	Corporate cost-out, overheads down -A$4.5m on the pcp
Total EBITDA	**38.2**	**41.2**	**7.8%**	**EBITDA including IFRS 16 of A$62.5m**
Depreciation & Amort.	(9.7)	(9.6)	-1.0%	
EBIT	**28.5**	**31.6**	**10.8%**	
Net Interest	(1.4)	(1.2)	-14.6%	Reduction in debt levels as a result of inventory management and lower dividend
Profit Before Tax	**27.2**	**30.5**	**12.0%**	
Tax	(7.7)	(8.9)	16.1%	Effective tax rate of 29%
Reported Profit	**19.5**	**21.6**	**10.5%**	
Abnormals	-	-	-	Expecting a remediation payment of ~A$22m in 2H20E
Normalised Profit	**19.5**	**21.6**	**10.5%**	
Underlying EPS	5.0	5.6	10.4%	
DPS (AUD)	2.5	1.5	-40.0%	Reduction reflects upcoming remediation payment
Balance sheet & Cashflow				
Operating Cashflow	24.8	67.0	170.7%	
Fixed Assets	66.6	57.4	-13.8%	Net two store closure
Working Capital	173.1	155.5	-10.2%	Inventory management
Net Debt	20.7	(0.4)	-101.8%	Working capital release and lower dividend enabled debt reduction
Shareholders Equity	200.9	179.9	-10.5%	
Inventory	220.2	200.1	-9.1%	Improved inventory reduction of -A$20m
Divisional analysis				
New Zealand	61.3	66.2	8.1%	Same store sales increased +6.6%
Australia	175.5	174.2	-0.7%	Same store sales increased +3.3%
Canada	77.9	88.5	13.7%	Same store sales increased +5.1%
Unallocated Sales	-	-	-	
Total Sales	**314.7**	**329.0**	**4.6%**	**Group SSS increased +6.3%**
EBIT analysis				
EBIT - New Zealand	14.1	13.7	-2.5%	
EBIT Margin	*23.0%*	*20.7%*	*-225bps*	
EBIT - Australia	24.6	22.7	-8.0%	
EBIT Margin	*14.0%*	*13.0%*	*-103bps*	
EBIT - Canada	8.9	8.8	-1.4%	
EBIT Margin	*11.4%*	*9.9%*	*-151bps*	
Corporate costs	(19.1)	(13.6)	-28.9%	Annualisation of cost-out, expect more to come
Total EBIT	**28.5**	**31.6**	**10.8%**	
EBIT Margin	*9.1%*	*9.6%*	*54bps*	

Source: Company reports, 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.

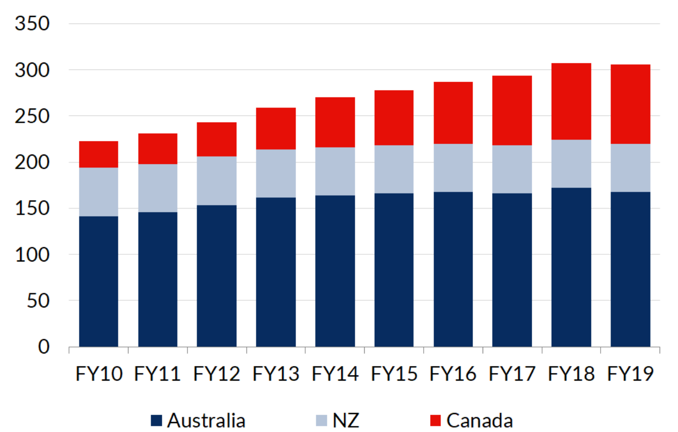
Financial structure

- **Gearing:** MHJ has reduced its debt levels in recent years as it exited underperforming businesses. As at 1H20, MHJ has a net cash position of A$0.4m.

Risk factors

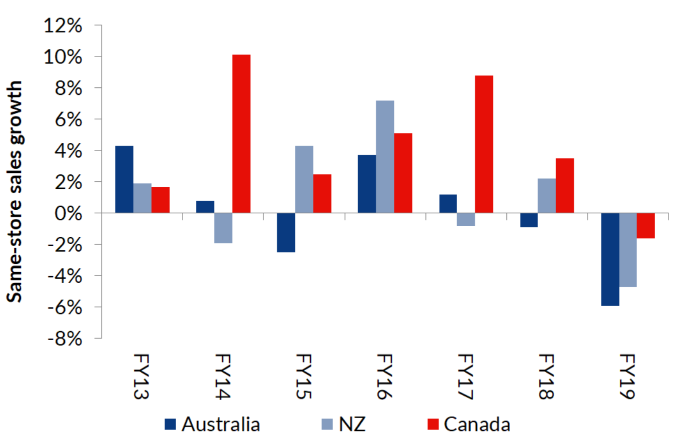
- **Consumer sentiment and retail backdrop:** MHJ's products are reliant on discretional spending. Jewellery chains that cater to the majority (e.g. MHJ) are typically less affected by economic fluctuations than luxury jewellers.
- **Competitor store closures:** The tough retail backdrop has seen competitor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

Figure 6. MHJ footprint by market



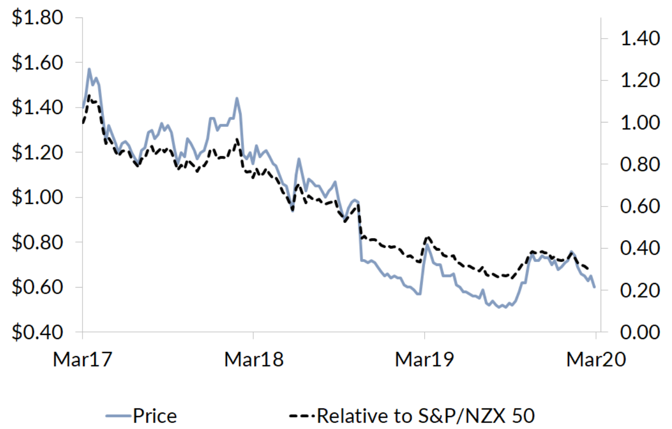
Source: Company reports, Forsyth Barr analysis

Figure 7. MHJ divisional same store sales growth



Source: Company reports, Forsyth Barr analysis

Figure 8. Price performance



Source: Forsyth Barr analysis

Figure 9. Substantial shareholders

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

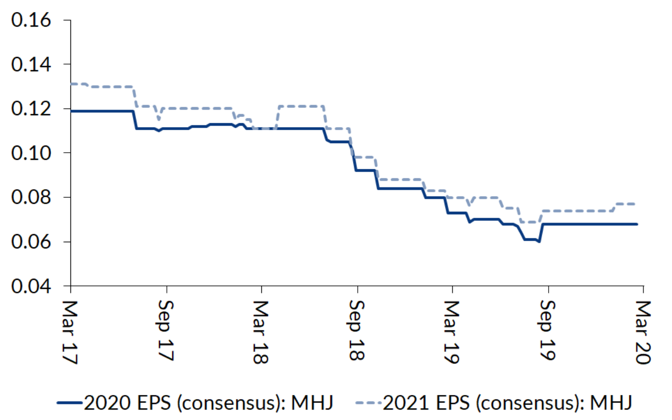
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 10. International valuation comparisons

Company	Code	Price	Mkt Cap	PE		EV/EBITDA		EV/EBIT		Cash Yld
(metrics re-weighted to reflect MHJ's balance date - June)			(m)	2020E	2021E	2020E	2021E	2020E	2021E	2021E
Michael Hill Intl	**MHJ NZ**	**NZ$0.60**	**NZ$229**	**8.9x**	**8.8x**	**4.3x**	**4.2x**	**6.4x**	**6.3x**	**8.7%**
Briscoe Group *	BGP NZ	NZ$3.82	NZ$849	13.5x	13.2x	8.3x	8.2x	8.9x	8.8x	5.9%
Kathmandu Holdings *	KMD NZ	NZ$3.38	NZ$997	12.6x	10.8x	7.5x	6.1x	9.1x	7.4x	5.6%
Restaurant Brands NZ *	RBD NZ	NZ$12.62	NZ$1,574	35.8x	31.2x	16.9x	15.3x	26.0x	23.4x	0.0%
The Warehouse Group *	WHS NZ	NZ$2.44	NZ$846	11.1x	9.7x	5.3x	4.7x	8.0x	7.1x	7.5%
SIGNET JEWELERS	SIG US	US$25.95	US$1,358	7.2x	7.6x	7.9x	8.3x	12.0x	n/a	6.2%
TIFFANY & CO	TIF US	US$133.98	US$16,229	28.5x	26.6x	17.3x	16.4x	22.7x	21.6x	1.9%
MYER HOLDINGS	MYR AT	A$0.37	A$300	8.6x	7.5x	2.1x	2.0x	5.8x	5.1x	3.3%
LOVISA HOLDINGS	LOV AT	A$11.04	A$1,168	32.4x	25.3x	18.8x	15.0x	23.4x	18.6x	3.1%
			Compco Average:	**18.7x**	**16.5x**	**10.5x**	**9.5x**	**14.5x**	**13.1x**	**4.2%**
EV = Current Market Cap + Actual Net Debt			**MHJ Relative:**	**-53%**	**-47%**	**-59%**	**-56%**	**-56%**	**-52%**	**107%**

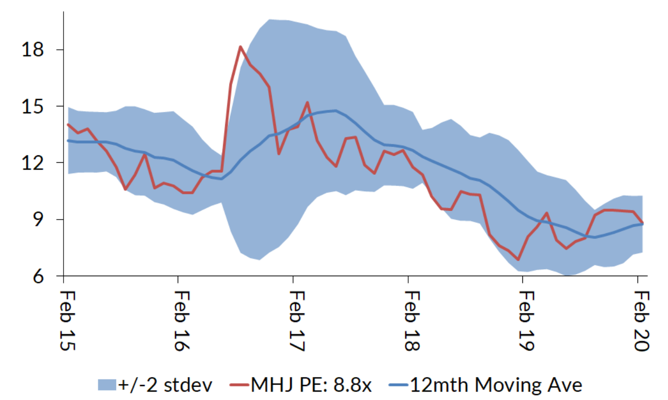
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (MHJ) companies fiscal year end

Figure 11. Consensus EPS momentum (NZ$)



Source: Forsyth Barr analysis

Figure 12. One year forward PE (x)



Source: Forsyth Barr analysis

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