

Michael Hill Intl

Canada Closing Doors

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NEUTRAL 

The near-term outlook for Michael Hill International (MHJ) and the whole retail sector is highly uncertain, however, we are of the view it is likely to get worse before it gets better. The global COVID-19 situation has developed rapidly over recent weeks and remains very fluid. MHJ has announced the closure of its Canada store network for a period of two weeks, in line with public health guidance, and we suspect more of MHJ's trading markets are likely to follow suit. We have made material cuts to our near term forecasts, and as such have lowered our target price -NZ\$0.20 to NZ\$0.45. Our NEUTRAL rating is unchanged, although we note the significant amount of uncertainty and see further downside risk should the economy enter a longer-term economic downturn.

NZX Code	MHJ	Financials: Jun/	19A	20E	21E	22E	Valuation (x)	19A	20E	21E	22E
Share price	NZ\$0.33	NPAT* (NZ\$m)	24.3	11.5	3.2	8.1	EV/EBITDA	2.7	3.9	5.8	4.7
Target price	NZ\$0.40	EPS* (NZc)	6.3	3.0	0.8	2.1	EV/EBIT	4.2	8.1	20.2	10.0
Risk rating	High	EPS growth* (%)	-29.0	-52.7	-72.1	n/a	PE	5.2	11.0	39.4	15.5
Issued shares	382.5m	DPS (NZc)	4.3	1.6	2.6	5.3	Price / NTA	0.7	0.8	0.9	1.0
Market cap	NZ\$126m	Imputation (%)	100	100	80	80	Cash div yld (%)	12.9	4.8	7.9	16.0
Avg daily turnover	81.3k (NZ\$376k)	*Based on normalised profits					Gross div yld (%)	17.9	6.7	10.3	20.9

Sales impact likely to deteriorate, in our opinion

Foot traffic through shopping centres is declining with uncertainty and self-isolation policies keeping consumers at home, with non-perishable essential staples also likely diverting spend away from more discretionary purchases. MHJ has announced store closures in Canada and we view the possibility of store closures across all of its trading markets as increasingly likely. This situation is unprecedented making forecasts highly uncertain. However, with activity returning in China, it provides a base case for expected retail disruption. We now assume c. five weeks of store closures across MHJ's trading markets, in line with the China experience highlighted by a number of multinationals, and have made the corresponding cuts to our forecasts. A near-term recovery appears unlikely, as a possible wider economic slowdown weighs on consumer confidence. Our forecasts assume the first period of positive same store sales (SSS) in FY22E. MHJ is expected to report its 3Q20 sales in early April 2020.

Unsurprisingly, MHJ is addressing its cost base; more flexible than normal

MHJ typically has a high degree of fixed costs, namely wage and lease costs (cost of doing business c. 70% fixed). However, we view this scenario as non-normal and therefore expect an element of flexibility during the peak of the virus disruption (store closures). In Canada, staff have been stood down (although leave entitlements or leave without pay are available) and the company is in discussions with landlords in all markets, seeking short-term rent relief. We suspect government responses, in the form of economic stimulus, may provide additional relief. To capture increased flexibility, we have assumed a limited period of reduced operating leverage (cost of doing business c. 40% fixed). We note the company is also reviewing labour costs across the business.

Balance sheet – better news

Heading into the COVID-19 pandemic MHJ's balance sheet was conservatively geared, FY19 net debt/EBITDA of 0.5x (excluding leases) and a net cash position at 1H20. MHJ also has access to an A\$110m multi-option bank facility maturing in June 2021, the majority of which is likely undrawn. MHJ has cut all non-essential capex near-term and we expect it to cut its FY20E final dividend to

provide additional balance sheet headroom. We estimate MHJ would have to see a c. -70% decline to our prior FY21E EBITDA forecast (a further -33% from our revised forecast) before raising a 2.5x net debt/EBITDA 'red flag'.

Michael Hill International Ltd (MHJ)

Priced as at 23 Mar 2020 (NZ\$)						0.33						
12-month target price (NZ\$)*						0.40	Spot valuations (NZ\$)					
Expected share price return						21.2%	1. DCF					0.47
Net dividend yield						7.1%	2. Sum of the parts					0.40
Estimated 12-month return						28.3%	3. n/a					n/a
Key WACC assumptions						DCF valuation summary (NZ\$m)						
Risk free rate						2.00%	Total firm value					206
Equity beta						1.15	(Net debt)/cash					(26)
WACC						9.8%	Less: Capitalised operating leases					
Terminal growth						1.5%	Value of equity					179
Profit and Loss Account (A\$m)						Valuation Ratios						
Sales revenue	2018A	2019A	2020E	2021E	2022E	2018A	2019A	2020E	2021E	2022E		
Normalised EBITDA	604.0	571.1	520.4	514.1	538.5	EV/EBITDA (x)	0.4	0.3	0.6	1.3	1.0	
Depreciation and amortisation	60.3	54.0	37.6	26.7	32.6	EV/EBIT (x)	0.7	0.5	1.2	4.5	2.2	
Normalised EBIT	(20.2)	(19.4)	(19.3)	(19.0)	(17.4)	PE (x)	3.7	5.2	11.0	39.4	15.5	
Net interest	40.1	34.6	18.3	7.6	15.2	Price/NTA (x)	0.7	0.7	0.8	0.9	1.0	
Associate income	(2.7)	(2.5)	(2.6)	(2.9)	(3.8)	Free cash flow yield (%)	24.5	18.4	6.2	5.5	-2.4	
Tax	0	0	0	0	0	Net dividend yield (%)	16.4	12.9	4.8	7.9	16.0	
Minority interests	(5.9)	(2.3)	(4.9)	(1.6)	(3.6)	Gross dividend yield (%)	16.4	12.9	4.8	7.9	16.0	
Normalised NPAT	0	0	0	0	0	Capital Structure						
Abnormals/other	31.5	22.8	10.9	3.1	7.7	Interest cover EBIT (x)	2018A	2019A	2020E	2021E	2022E	
Reported NPAT	(26.9)	(6.3)	(22.0)	0	0	Interest cover EBITDA (x)	0.2	0.2	0.1	0.0	0.1	
Normalised EPS (cps)	4.6	16.5	(11.1)	3.1	7.7	Net debt/ND+E (%)	0.1	0.1	0.1	0.0	0.0	
DPS (cps)	8.1	5.9	2.8	0.8	2.0	Net debt/EBITDA (x)	100.0	100.0	100.0	100.0	100.0	
	5.0	4.0	1.5	2.5	5.0	Key Ratios						
						2018A	2019A	2020E	2021E	2022E		
						Return on assets (%)	10.7	9.1	5.3	2.2	4.3	
						Return on equity (%)	16.6	16.9	6.5	2.0	5.6	
						Return on funds employed (%)	15.8	15.7	6.4	3.3	6.3	
						EBITDA margin (%)	10.0	9.5	7.2	5.2	6.0	
						EBIT margin (%)	6.6	6.1	3.5	1.5	2.8	
						Capex to sales (%)	4.0	2.7	3.6	3.6	4.2	
						Capex to depreciation (%)	119	81	96	96	129	
						Imputation (%)	100	100	100	80	80	
						Pay-out ratio (%)	61	67	53	311	248	
						Operating Performance						
						2018A	2019A	2020E	2021E	2022E		
						Divisional revenue (A\$m)						
						New Zealand	115.4	113.0	105.4	103.5	107.4	
						Australia	325.7	313.6	287.8	281.8	290.3	
						Canada	133.0	140.4	125.5	127.1	139.0	
						Other	29.9	4.1	1.6	1.7	1.8	
						Total revenue	604.0	571.1	520.4	514.1	538.5	
						Divisional EBIT (A\$m)						
						New Zealand	25.6	22.7	18.3	15.8	18.4	
						Australia	48.6	32.9	22.8	14.0	19.1	
						Canada	14.9	10.2	3.3	2.9	7.7	
						Corporate and other	(49.0)	(31.3)	(26.0)	(25.0)	(30.0)	
						Total EBIT	40.1	34.6	18.3	7.6	15.2	
						Store numbers						
						New Zealand	52	52	52	52	52	
						Australia	172	168	164	161	161	
						Canada	83	86	87	87	87	
Balance Sheet (NZ\$m)												
Working capital	2018A	2019A	2020E	2021E	2022E							
Fixed assets	155.6	131.8	142.1	140.2	147.2							
Intangibles	66.7	63.2	62.4	61.7	66.8							
Right of use asset	12.6	15.4	15.4	15.4	15.4							
Other assets	0	0	0	0	0							
Total funds employed	306.3	293.9	287.3	282.8	292.9							
Net debt/(cash)	28.0	24.8	32.5	35.3	57.7							
Lease liability	0	0	0	0	0							
Other liabilities	89.1	92.4	87.8	92.1	96.6							
Shareholder's funds	189.2	176.8	167.1	155.5	138.6							
Minority interests	0	0	0	0	0							
Total funding sources	306.3	293.9	287.3	282.8	292.9							

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

COVID-19 Implications

The global outbreak of COVID-19 is causing unprecedented and widespread disruption. The retail sector has seen declining foot traffic as governments around the world encourage social distancing, and discretionary spend is diverted towards more essential purchases. As the situation develops many markets are beginning to experience mass retail door closures.

We have explored the financial implications for MHJ of COVID-19, although note that the situation is very fluid and changing daily.

Earnings and valuation changes

We have made material negative revisions to our forecasts, lowering FY20E and FY21E Normalised NPAT -56% to NZ\$10.9m and -88% to NZ\$3.1m respectively. This reflects substantial changes to our near-term same store sales (SSS) forecasts across all markets and assumptions made around the addressable cost base. We assume more flexible lease and wage cost outcomes during the peak of the virus related disruption before returning to a more normal fixed/variable cost mix. We have also materially reduced our near-term capex assumptions and now do not expect any final dividend. We also see risk to the 1H21E interim dividend.

Our target price falls to NZ\$0.45 from NZ\$0.65 (-31%), reflecting the material decline in both our earnings forecasts and market multiples. Our NEUTRAL rating remains unchanged, however, we note the significant amount of risk during times of heightened uncertainty, and see further downside risk should the economy enter a longer-term economic downturn.

Figure 1. Earnings changes (A\$m)

Forecast changes (A\$m)	FY20E			FY21E			FY22E		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Sales Revenue	585.5	520.4	-11.1%	591.3	514.1	-13.1%	597.8	538.5	-9.9%
EBIT	38.0	18.3	-51.7%	39.2	7.6	-80.5%	40.6	15.2	-62.6%
Normalised Profit	24.5	10.9	-55.8%	25.1	3.1	-87.7%	26.2	7.7	-70.5%
Underlying EPS (cps)	6.3	2.8	-55.8%	6.5	0.8	-87.7%	6.8	2.0	-70.5%
DPS (cps, AUD)	3.0	1.5	-50.0%	5.0	2.5	-50.0%	5.0	5.0	-

Source: Forsyth Barr analysis

Canada closing its doors; more markets look likely to follow

MHJ has announced it will temporarily close all of its Canada store doors for a period of two weeks, in line with public health guidance in Canada. The store closures are subject to continuous review and will be lifted/extended as necessary, although two weeks would represent ~1% of group total sales.

Foot traffic through shopping centres in all of MHJ's markets is declining, with uncertainty and self-isolation policies keeping consumers at home. In addition, spend is likely being diverted away from more discretionary purchases towards non-perishable essential staples. We have seen retailers close store doors in many markets, with at least two examples emerging recently in Australasian markets; [Patagonia](#) and [Icebreaker](#). We continue to monitor the situation, and view the possibility of MHJ store closures in Australia and New Zealand as increasingly likely, with two Australian states signalling shut down of all non-essential activity.

China experienced c. five weeks of door closures

The COVID-19 outbreak originated in the Chinese province of Hubei in late 2019, eventually spreading throughout China and into the major centres. Many international retailers were forced to shut their doors in China. Activity is now beginning to return to China with ~90% of major retail stores open again, albeit at reduced hours and in some cases traffic limitations. The China experience provides a level of insight into the sales disruption we might expect in other markets.

Multinational jewellery retailer Tiffany & Co announced that due to door closures and reduced store hours in China, between 24 January and 19 March it lost the equivalent of 30 of its 54 trading days.

Sales to decline across all markets

MHJ has highlighted a significant drop in foot traffic across all trading markets. With the virus scenario evolving rapidly, we now expect to see store closures in Australia and New Zealand over the coming weeks, either mandated, or as a result of a material decline in activity. We have made corresponding cuts to our FY20E same store sales assumptions across all markets on the basis of c. five weeks of store closures (based on the China example). We do not assume a recovery until FY22E, although note downside risk should any prolonged economic slowdown arise.

Addressing the cost base

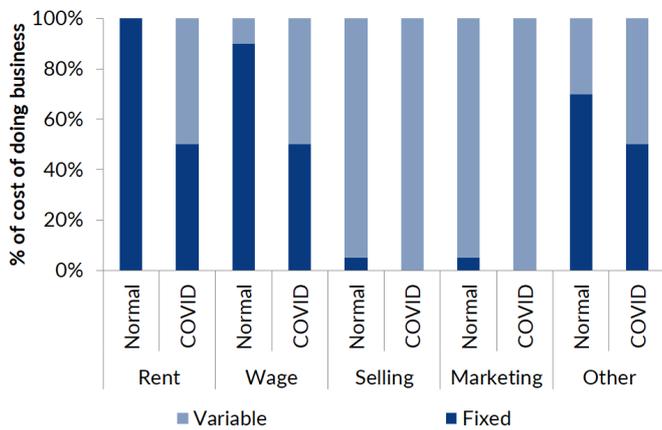
MHJ has a high degree of operating leverage with a large fixed cost base, namely occupancy and wage expenses. We estimate under normal conditions MHJ's cost of doing business is ~70% fixed, with the remaining ~30% linked to promotional activity and selling expenses. Unsurprisingly, MHJ is reviewing all of its costs in order to optimise its cost of doing business.

... These are non-normal conditions

We have assumed additional flexibility on the 'fixed' cost base during the peak virus period. In Canada, MHJ has stood down the majority of its staff (although leave entitlements or leave without pay are available), it is also in negotiations with landlords in regards to temporary rent relief. The Canadian Government has announced wage subsidies as a part of its stimulus package and has in place a programme of wage insurance. Other governments have also announced or are due to announce further stimulus packages, which may include measures to help affected businesses address wage costs.

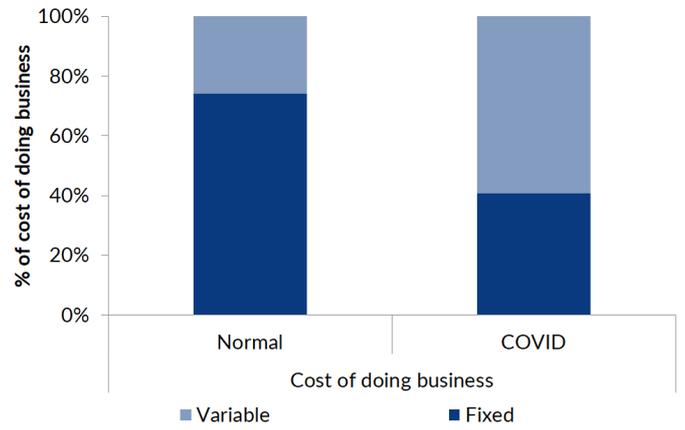
Our revised forecasts assume both rent and wage expenses are 50% variable during the peak virus period (c. five weeks).

Figure 2. MHJ cost of doing business categories



Source: Forsyth Barr analysis

Figure 3. More flexible cost base during COVID-19



Source: Forsyth Barr analysis

Balance sheet passes health check

Heading into the COVID-19 pandemic, MHJ's balance sheet was conservatively geared with FY19 net debt/EBITDA of 0.5x (excluding leases) and a net cash position at 1H20 (total lease liability of A\$167m). MHJ also has access to A\$110m multi-option bank facility maturing in June 2021, the majority likely undrawn. We estimate MHJ would have to see a c. -70% decline to our prior FY21E EBITDA forecast (a further -33% from our revised forecast) before raising a 2.5x net debt/EBITDA 'red flag'.

Unsurprisingly, MHJ has halted all non-essential capital expenditure (prior FY20 capex guidance of A\$20m-A\$25m). We have subsequently lowered our FY20E and FY21E capex forecasts -18% to NZ\$18.5m and -19% to NZ\$18.3m respectively. We also no longer expect an FY20E final dividend.

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.
- **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.

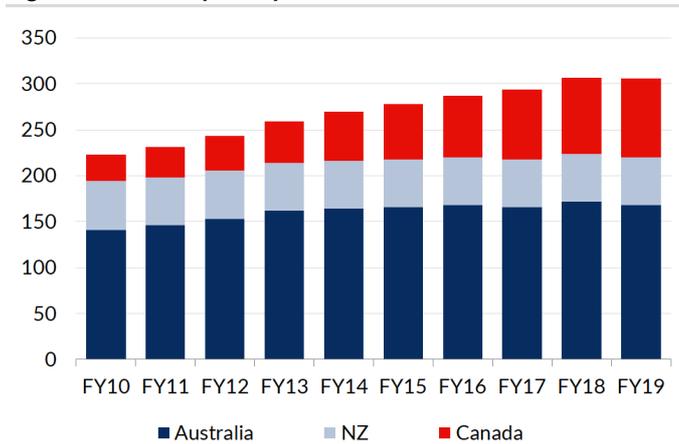
Financial structure

- **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

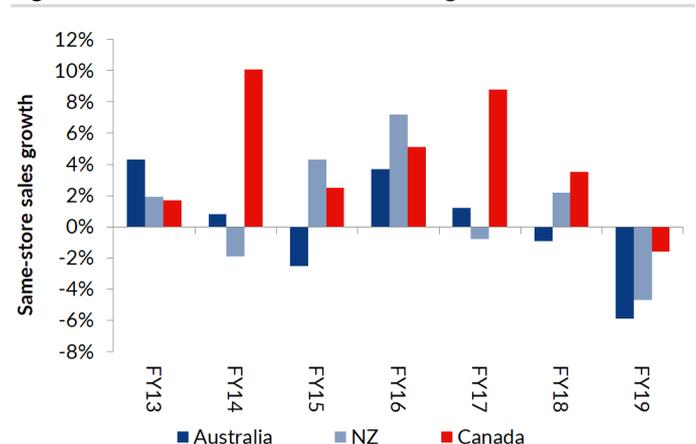
- **Consumer sentiment and retail backdrop:** MHJ’s products are reliant on discretionary spending. Jewellery chains that cater to the majority (e.g. MHJ) are typically less affected by economic fluctuations than luxury jewellers.
- **Competitor store closures:** The tough retail backdrop has seen competitor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

Figure 4. MHJ footprint by market



Source: Company reports, Forsyth Barr analysis

Figure 5. MHJ divisional same store sales growth



Source: Company reports, Forsyth Barr analysis

Figure 6. Substantial shareholders

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

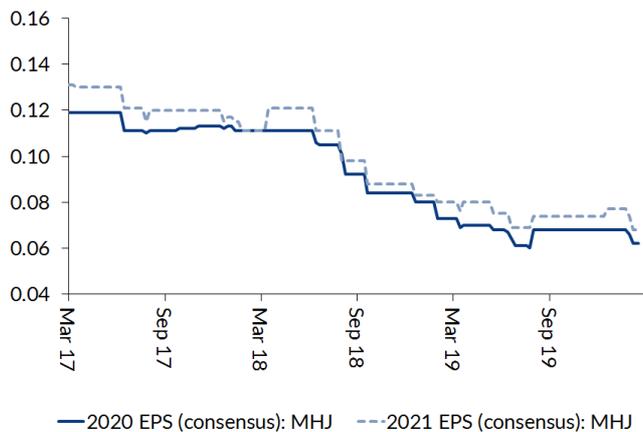
Source: NZX, Forsyth Barr analysis, NOTE: based on SSH notices only

Figure 7. International valuation comparisons

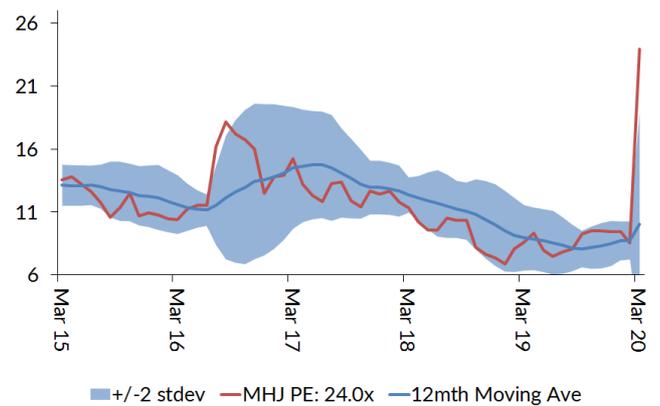
Company (metrics re-weighted to reflect MHJ's balance date - June)	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash Yld 2021E
				2020E	2021E	2020E	2021E	2020E	2021E	
Michael Hill Intl	MHJ NZ	NZ\$0.33	NZ\$126	11.0x	39.4x	3.8x	5.5x	7.9x	19.2x	7.9%
Briscoe Group *	BGP NZ	NZ\$2.59	NZ\$576	9.3x	9.3x	4.1x	4.1x	5.2x	5.2x	8.7%
Kathmandu Holdings *	KMD NZ	NZ\$0.97	NZ\$286	3.6x	3.1x	2.3x	1.8x	2.7x	2.2x	19.4%
Restaurant Brands NZ *	RBD NZ	NZ\$7.87	NZ\$982	21.7x	17.5x	10.9x	8.0x	16.2x	12.2x	0.0%
The Warehouse Group *	WHS NZ	NZ\$2.03	NZ\$704	9.9x	8.4x	4.7x	4.1x	7.3x	6.3x	9.1%
SIGNET JEWELERS	SIG US	US\$7.74	US\$405	2.6x	3.1x	6.6x	7.4x	14.9x	n/a	20.8%
TIFFANY & CO	TIF US	US\$125.44	US\$15,202	27.4x	25.5x	14.7x	16.9x	22.7x	22.4x	2.0%
MYER HOLDINGS	MYR AT	A\$0.10	A\$78	2.8x	2.2x	11.4x	10.8x	32.3x	28.2x	14.5%
LOVISA HOLDINGS	LOV AT	A\$4.02	A\$432	13.3x	10.2x	8.2x	6.6x	12.0x	8.2x	7.6%
Compco Average:				11.3x	9.9x	7.9x	7.5x	14.2x	12.1x	10.3%
MHJ Relative:				-3%	298%	-51%	-26%	-44%	59%	-23%

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 8. Consensus EPS momentum (NZ\$)


Source: Forsyth Barr analysis

Figure 9. One year forward PE (x)


Source: Forsyth Barr analysis

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