

Michael Hill Intl

4Q20 Sales Checkout

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NEUTRAL 

Michael Hill International (MHJ) reported a material decline in 4Q20 sales, although commentary suggests recent trading is improving. Amid a difficult sales period, MHJ achieved a lift in gross margin against the prior year as it delivered on its strategy with continued growth in branded collection sales. There remains a high degree of uncertainty in the near-term outlook for MHJ and we retain a cautious view given 1) heightened levels of economic and consumer uncertainty, 2) discretionary category exposure, and 3) strategy execution risk. However, MHJ is trading at undemanding trailing multiples and we view the current price as factoring in those risks; reiterate NEUTRAL.

NZX Code	MHJ	Financials: Jun/	19A	20E	21E	22E	Valuation (x)	19A	20E	21E	22E
Share price	NZ\$0.34	NPAT* (NZ\$m)	24.3	12.1	4.1	9.0	EV/EBITDA	2.8	3.9	5.3	4.4
Target price	NZ\$0.40	EPS* (NZc)	6.3	3.2	1.1	2.4	EV/EBIT	4.3	7.8	17.7	9.3
Risk rating	High	EPS growth* (%)	-29.0	-50.0	-66.1	n/a	PE	5.4	10.7	31.7	14.4
Issued shares	382.5m	DPS (NZc)	4.3	1.6	1.6	2.7	Price / NTA	0.8	0.8	0.8	0.9
Market cap	NZ\$130m	Imputation (%)	100	100	80	80	Cash div yld (%)	12.5	4.6	4.7	7.9
Avg daily turnover	225.3k (NZ\$106k)	*Based on normalised profits					Gross div yld (%)	17.4	6.4	6.2	10.4

4Q20 defined by COVID impacts

MHJ 4Q20 group sales fell -61% on the prior period as store doors temporarily closed across its operating markets. On an adjusted basis (comparable trading days), group same store sales (SSS) fell -4.6% in the quarter, with staggered store openings and a surge in online sales (+198%). On a full year basis, FY20 sales fell -14% on the prior period. After adjusting for comparable trading days, FY20 SSS were ahead, up +2.7%. Heading into FY21, ~90% of MHJ stores have re-opened, with commentary suggesting sales performance continues to improve.

Gross margin improvements encouraging

Positively, gross margin improved +200bp in 4Q20 (vs prior year period), marking a second consecutive quarter of improvement and illustrating execution of key initiatives. Gross margin has been a key question for investors following a period at suppressed levels. Whilst it is encouraging to see MHJ deliver margin gains, we note it is early days and would want to see further improvements before gaining additional confidence to lift our longer-term margin assumptions.

Outlook uncertain but balance sheet in good condition

We have a cautious view on the outlook for the retail sector, particularly as government wage subsidies roll off and the economic realities become clearer. However, ongoing wage support, a leaner head office structure, and rent negotiations provide a level of earnings support into FY21. COVID-19 has provided a catalyst for many companies to review cost structures, and whilst improvements are a positive, the question remains as to how enduring these are.

The recent jump in COVID-19 cases and subsequent lockdown in Victoria highlights the risk of further COVID-19 disruption. MHJ's balance sheet appears well placed to weather further disruption, with net debt lower than FY19 levels (FY20E A\$23m, 0.5x net debt/FY19 EBITDA).

Michael Hill International Ltd (MHJ)

Priced as at 16 Jul 2020 (NZ\$)						0.34						
12-month target price (NZ\$)*						0.40	Spot valuations (NZ\$)					
Expected share price return						17.6%	1. DCF					0.32
Net dividend yield						4.6%	2. Sum of the parts					0.40
Estimated 12-month return						22.3%	3. n/a					n/a
Key WACC assumptions						DCF valuation summary (NZ\$m)						
Risk free rate						2.00%	Total firm value					150
Equity beta						1.15	(Net debt)/cash					(26)
WACC						9.8%	Less: Capitalised operating leases					
Terminal growth						1.5%	Value of equity					124
Profit and Loss Account (A\$m)						Valuation Ratios						
Sales revenue	2018A	2019A	2020E	2021E	2022E	EV/EBITDA (x)	2018A	2019A	2020E	2021E	2022E	
Normalised EBITDA	604.0	571.1	487.7	509.2	530.5	EV/EBIT (x)	0.5	0.4	0.9	1.8	1.5	
Depreciation and amortisation	60.3	54.0	38.1	27.2	32.7	PE (x)	0.7	0.6	1.7	6.0	3.2	
Normalised EBIT	(20.2)	(19.4)	(19.3)	(19.0)	(17.4)	Price/NTA (x)	3.8	5.4	10.7	31.7	14.4	
Net interest	40.1	34.6	18.9	8.2	15.3	Free cash flow yield (%)	0.7	0.8	0.8	0.8	0.9	
Associate income	(2.7)	(2.5)	(2.2)	(2.3)	(2.9)	Net dividend yield (%)	23.8	17.9	13.6	-0.2	-1.1	
Tax	0	0	0	0	0	Gross dividend yield (%)	16.0	12.5	4.6	4.7	7.9	
Minority interests	(5.9)	(2.3)	(5.1)	(2.0)	(3.9)	Capital Structure						
Normalised NPAT	0	0	0	0	0	Interest cover EBIT (x)	2018A	2019A	2020E	2021E	2022E	
Abnormals/other	31.5	22.8	11.5	3.8	8.4	Interest cover EBITDA (x)	0.2	0.2	0.1	0.0	0.1	
Reported NPAT	(26.9)	(6.3)	(22.0)	0	0	Net debt/ND+E (%)	0.1	0.1	0.1	0.0	0.0	
Normalised EPS (cps)	4.6	16.5	(10.5)	3.8	8.4	Net debt/EBITDA (x)	100.0	100.0	100.0	100.0	100.0	
DPS (cps)	8.1	5.9	3.0	1.0	2.2	Key Ratios						
	5.0	4.0	1.5	1.5	2.5	Return on assets (%)	2018A	2019A	2020E	2021E	2022E	
						Return on equity (%)	10.7	9.1	5.7	2.4	4.4	
						Return on funds employed (%)	16.6	16.9	6.9	2.4	5.4	
						EBITDA margin (%)	15.8	15.7	6.7	3.4	6.1	
						EBIT margin (%)	10.0	9.5	7.8	5.3	6.2	
						Capex to sales (%)	6.6	6.1	3.9	1.6	2.9	
						Capex to depreciation (%)	4.0	2.7	3.8	3.6	4.2	
						Imputation (%)	119	81	96	96	129	
						Pay-out ratio (%)	100	100	100	80	80	
						Operating Performance						
						Divisional revenue (A\$m)						
						New Zealand	2018A	2019A	2020E	2021E	2022E	
						Australia	115.4	113.0	101.6	98.9	101.6	
						Canada	325.7	313.6	266.3	281.8	290.3	
						Other	133.0	140.4	118.2	126.8	136.7	
						Total revenue	29.9	4.1	1.6	1.7	1.8	
						Divisional EBIT (A\$m)						
						New Zealand	604.0	571.1	487.7	509.2	530.5	
						Australia	25.6	22.7	19.8	15.1	16.8	
						Canada	48.6	32.9	21.7	15.6	21.4	
						Corporate and other	14.9	10.2	0.4	2.5	7.1	
						Total EBIT	(49.0)	(31.3)	(23.0)	(25.0)	(30.0)	
						Store numbers						
						New Zealand	40.1	34.6	18.9	8.2	15.3	
						Australia	52	52	49	49	49	
						Canada	172	168	155	155	155	
							83	86	86	86	86	
Balance Sheet (NZ\$m)												
Working capital	2018A	2019A	2020E	2021E	2022E							
Fixed assets	155.6	131.8	132.7	138.9	144.9							
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	71.4	83.5	67.4	65.4	63.4							
Net debt/(cash)	306.3	293.9	278.0	281.4	290.6							
Lease liability	28.0	24.8	22.5	28.6	39.7							
Other liabilities	0	0	0	0	0							
Shareholder's funds	89.1	92.4	87.5	91.8	96.2							
Minority interests	189.2	176.8	168.0	161.1	154.6							
Total funding sources	0	0	0	0	0							
	306.3	293.9	278.0	281.4	290.6							

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

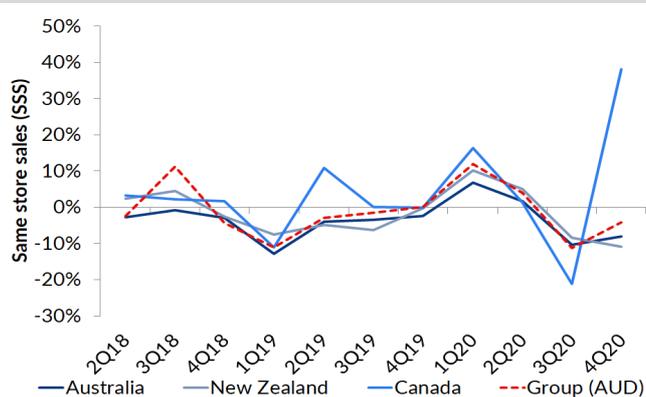
4Q20 sales

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

	1Q19	2Q19	3Q19	4Q19	1Q20	2Q20	3Q20	4Q20
Australia	66.7	106.9	65.5	72.0	68.3	105.9	58.3	33.1
New Zealand	23.4	41.6	25.5	28.6	26.2	43.9	23.7	13.0
Canada	23.7	48.7	26.2	31.3	27.9	50.5	21.2	6.7
Total (AUD)	113.0	197.1	117.6	132.6	124.0	203.5	105.1	52.5

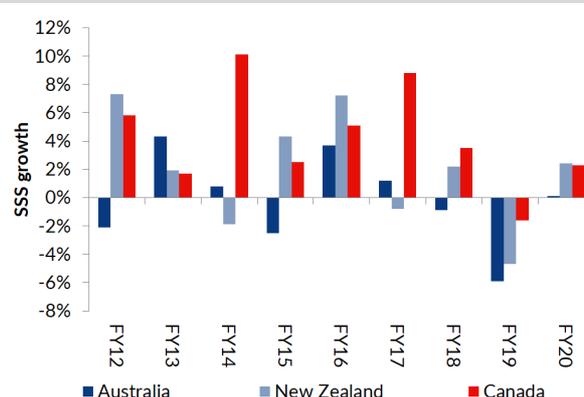
Source: Company reports, Forsyth Barr analysis

Figure 2. Quarterly same store sales growth*



Source: Company reports, Forsyth Barr analysis, *4Q20 SSS adjusted for store trading days

Figure 3. Annual same store sales growth*



Source: Company reports, *FY20 SSS adjusted for store trading days

Divisional insight

- **Australia** – Adjusted same store sales (SSS) fell -8.1% in 4Q20 (+0.1% FY20), and seven stores were permanently closed in the period. As at the end of 4Q20, only 148 stores of 155 are currently open.
- **New Zealand** – Quarterly SSS fell -10.9% (+2.4% FY20), and three stores were permanently closed in the period.
- **Canada** – A highlight, with SSS up +38% in 4Q20 due to strong online and delayed store openings. One store was permanently closed in the quarter. As at the end of 4Q20, only 70 stores of 86 are currently open.
- **Online** – 4Q20 online surged, up +193% on the prior year period. For the year, online penetration was 4.6% (2.8% in FY19).
 - Although off a low base and supported by bricks & mortar closures, online growth is encouraging. Completion of its ERP platform should help accelerate further gains by enabling click & collect and ship from store.

Earnings changes

We adjust our FY20E forecasts to reflect updated sales figures, with our earnings estimates increasing as we lift our gross margin assumption on management commentary, and factor in further wage subsidies and rental relief. Our FY21E forecasts also lift on the back of wage subsidy extensions and cost out initiatives, increasing NPAT +A\$0.6m. Minimal changes further out.

We have made no changes to our target price of NZ\$0.40.

Figure 4. Earnings changes (A\$m)

	FY20E			FY21E			FY22E		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Sales Revenue	520.4	487.7	-6.3%	514.1	509.2	-0.9%	538.5	530.5	-1.5%
EBIT	18.3	18.9	2.8%	7.6	8.2	6.9%	15.2	15.3	0.6%
Normalised Profit	10.9	11.5	6.1%	3.1	3.8	25.1%	7.7	8.4	8.4%
Underlying EPS	2.8	3.0	6.1%	0.8	1.0	25.1%	2.0	2.2	8.4%
DPS (AUD)	1.5	1.5	-	2.5	1.5	-40.0%	5.0	2.5	-50.0%

Source: Forsyth Barr analysis

Investment Summary

Michael Hill (MHJ) has exited loss-making divisions (Emma & Roe and the US) and is now focussing solely on the Michael Hill brand, with extensive strategic change underway. We are positive on this strategic directional shift; however, we are cautious given the extensive execution involved with branding and pricing strategy changes. We expect modest medium-to-longer term growth from its more mature NZ and Australian divisions. There also remains opportunity for Canada through store productivity improvements. However, significant near-term uncertainty exists for retail companies from the impacts of COVID-19, with duration of operating restrictions unknown. NEUTRAL.

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:** The near-term outlook for sales is highly uncertain with COVID-19 related disruption in all markets and a slower economic outlook post lock down policies.
- **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.

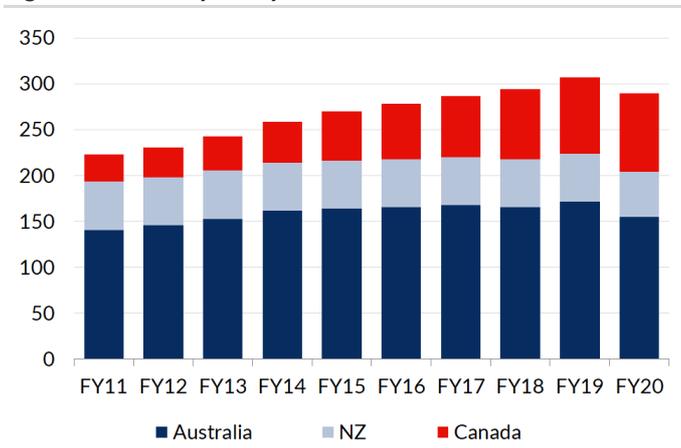
Financial structure

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

Risk factors

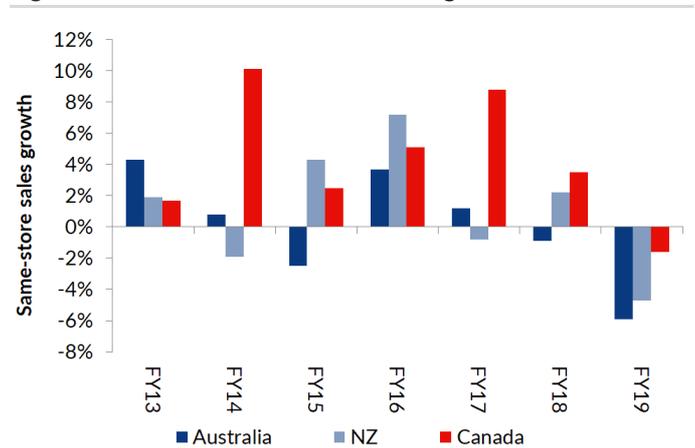
- **Consumer sentiment and retail backdrop:** MHJ's products are reliant on discretionary spending. Jewellery chains that cater to the majority (e.g. MHJ) are typically less affected by economic fluctuations than luxury jewellers.
- **Competitor store closures:** The tough retail backdrop has seen competitor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

Figure 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
Hoglett Hamlett Limited	38.3%
ACC	7.4%

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

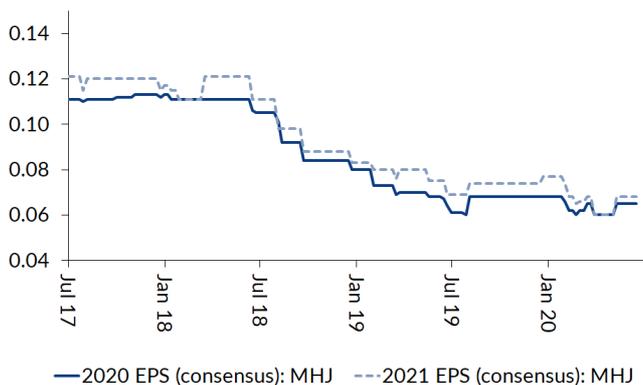
Figure 9. International valuation comparisons

Company	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash Yld
(metrics re-weighted to reflect MHJ's balance date - June)										
				2020E	2021E	2020E	2021E	2020E	2021E	2021E
Michael Hill Intl	MHJ NZ	NZ\$0.34	NZ\$130	10.7x	31.7x	3.9x	5.4x	7.9x	18.0x	4.7%
SIGNET JEWELERS	SIG US	US\$11.74	US\$614	1.9x	<0x	21.0x	n/a	4.8x	n/a	1.9%
LOVISA HOLDINGS	LOV AT	A\$6.27	A\$674	31.8x	25.3x	14.6x	12.3x	24.7x	19.5x	2.4%
MYER HOLDINGS	MYR AT	A\$0.21	A\$172	11.3x	7.6x	9.0x	9.4x	27.4x	34.8x	3.5%
TIFFANY & CO	TIF US	US\$122.50	US\$14,865	45.5x	>50x	19.7x	24.9x	33.8x	39.6x	1.8%
KATHMANDU HOLDINGS*	KMD NZ	NZ\$1.16	NZ\$822	15.4x	18.4x	11.6x	9.3x	17.3x	13.4x	2.4%
BRISCOE GROUP*	BGP NZ	NZ\$3.19	NZ\$709	16.7x	19.9x	7.2x	7.5x	10.2x	10.6x	3.7%
THE WAREHOUSE GROUP*	WHS NZ	NZ\$2.09	NZ\$725	9.8x	19.8x	4.7x	6.8x	7.2x	13.8x	3.0%
Compco Average:				18.9x	18.2x	12.6x	11.7x	17.9x	21.9x	2.7%
MHJ Relative:				-43%	74%	-69%	-54%	-56%	-18%	77%

EV = Current Market Cap + Actual Net Debt

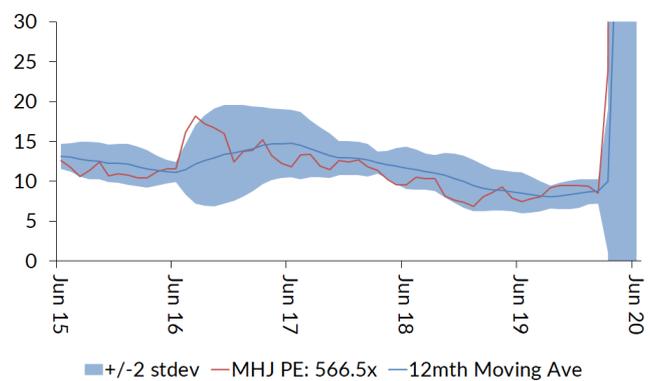
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (MHJ) companies fiscal year end

Figure 10. Consensus EPS momentum (NZ\$)



Source: Forsyth Barr analysis

Figure 11. One year forward PE (x)



Source: Forsyth Barr analysis

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