

Michael Hill Intl

An Early Christmas Present

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OUTPERFORM

Michael Hill's (MHJ) trading update highlighted both strong sales performance and margin expansion in the 22 weeks to end November. We expect MHJ is benefitting from both a supportive operating environment and execution on strategic changes made. An elevated level of earnings risk exists with 1) economic uncertainty, and 2) a North American business exposed to a fluid COVID-19 backdrop. However, at 8x forward PE, with an 8% cash yield, and a strong balance sheet we think investors are being compensated for that risk. OUTPERFORM.

NZX Code	MHJ	Financials: Jun/	20A	21E	22E	23E	Valuation (x)	20A	21E	22E	23E
Share price	NZ\$0.63	NPAT* (NZ\$m)	15.6	32.6	28.2	29.3	PE	15.5	7.4	8.5	8.2
Target price	NZ\$0.68	EPS* (NZc)	4.1	8.5	7.4	7.7	EV/EBIT	9.6	6.8	7.7	7.4
Risk rating	High	EPS growth* (%)	-35.9	n/a	-13.3	3.8	EV/EBITDA	3.4	3.4	3.6	3.5
Issued shares	382.5m	DPS (NZc)	1.6	4.9	4.9	5.5	Price / NTA	1.3	1.1	1.1	1.1
Market cap	NZ\$241m	Imputation (%)	100	80	80	80	Cash div yld (%)	2.5	7.7	7.8	8.7
Avg daily turnover	331.1k (NZ\$134k)	*Based on normalised profits					Gross div yld (%)	3.5	10.1	10.3	11.4

What's changed?

- **Earnings:** We lift our FY21E EBIT forecast +28% to A\$49m reflecting strong sales to date alongside gross margin expansion. Our FY22E and FY23E forecast lift +12% and +8% to A\$43m and A\$44m respectively as we factor in margin and operating cost improvements.
- **Dividend:** We lift our near-term dividend assumptions materially with strong earnings and working capital management driving further cash generation. MHJ now offers a forward cash yield of 8%.
- **Target price:** Our target price lifts +13cps to NZ\$0.68 driven principally by positive earnings revisions.

Sales momentum continues

MHJ group same store sales (SSS) have increased +7.9% year on year for the 22 week period end November, accelerating into the Christmas trading period (+8.5% for October/November). Australia has been the standout year to date, with SSS growth of +14%. New Zealand and Canada SSS increased +3.6% and +5.5% respectively, while online sales lifted +110%.

Margin expansion the highlight

MHJ has shifted its strategic priority back towards margin expansion, having previously emphasised sales and market share. Gross margin for the 22 week period is c. +200bp above the prior year period, with strategic changes put in place around branded collections and inventory management beginning to pay dividends. MHJ has signalled a material lift in 1H21 underlying EBIT against the prior year (1H20 A\$31.6m), before taking into account wage subsidies captured in the period (c. A\$13m).

Christmas period to come

Whilst trading to date has been strong, the seasonally important Christmas sales period is to come. Although elevated economic and COVID-19 uncertainty exists, we view MHJ as well positioned given improving economic sentiment, continued consumer momentum, and improvements in inventory quality. In addition, MHJ's balance sheet remains healthy and is likely to report a meaningful net cash balance at its interim result.

Michael Hill International Ltd (MHJ)

Priced as at 10 Dec 2020 (NZ\$)						0.63						
12-month target price (NZ\$)*						0.68	Spot valuations (NZ\$)					
Expected share price return						7.9%	1. DCF					0.60
Net dividend yield						7.8%	2. Sum of the parts					0.67
Estimated 12-month return						15.7%	3. n/a					n/a
Key WACC assumptions						DCF valuation summary (NZ\$m)						
Risk free rate						1.30%	Total firm value					682
Equity beta						1.15	(Net debt)/cash					1
WACC						7.6%	Less: Capitalised operating leases					453
Terminal growth						1.5%	Value of equity					230
Profit and Loss Account (A\$m)						Valuation Ratios						
	2019A	2020A	2021E	2022E	2023E		2019A	2020A	2021E	2022E	2023E	
Sales revenue	571.1	512.6	525.3	519.7	534.0	EV/EBITDA (x)	2.3	1.5	1.6	1.9	1.9	
Normalised EBITDA	54.0	86.8	99.0	91.0	92.0	EV/EBIT (x)	3.6	4.1	3.2	4.1	4.0	
Depreciation and amortisation	(19.4)	(55.6)	(50.1)	(48.6)	(48.2)	PE (x)	9.9	15.5	7.4	8.5	8.2	
Normalised EBIT	34.6	31.2	48.9	42.5	43.8	Price/NTA (x)	1.4	1.3	1.1	1.1	1.1	
Net interest	(2.5)	(9.6)	(8.4)	(8.0)	(8.1)	Free cash flow yield (%)	9.7	27.6	20.8	17.9	17.3	
Associate income	0	0	0	0	0	Net dividend yield (%)	6.7	2.5	7.7	7.8	8.7	
Tax	(2.3)	(1.4)	(10.4)	(8.7)	(9.1)	Gross dividend yield (%)	9.4	3.5	10.1	10.3	11.4	
Minority interests	0	0	0	0	0	Capital Structure						
Normalised NPAT	22.8	14.8	30.1	25.8	26.7	Interest cover EBIT (x)	14.0	3.3	5.8	5.3	5.4	
Abnormals/other	(6.3)	(11.7)	0	0	0	Interest cover EBITDA (x)	21.9	9.1	11.8	11.4	11.3	
Reported NPAT	16.5	3.1	30.1	25.8	26.7	Net debt/ND+E (%)	12.3	-0.3	-4.4	-5.3	-4.4	
Normalised EPS (cps)	5.9	3.8	7.8	6.6	6.9	Net debt/EBITDA (x)	0.5	n/a	n/a	n/a	n/a	
DPS (cps)	4.0	1.5	4.5	4.5	5.0	Key Ratios						
Growth Rates							2019A	2020A	2021E	2022E	2023E	
Revenue (%)	-5.5	-10.2	2.5	-1.1	2.8	Return on assets (%)	9.1	6.2	10.4	9.1	9.2	
EBITDA (%)	-10.4	60.9	14.0	-8.0	1.1	Return on equity (%)	16.9	10.3	13.6	11.6	12.1	
EBIT (%)	-13.7	-9.7	56.5	-13.1	3.2	Return on funds employed (%)	15.7	14.9	19.0	17.5	18.3	
Normalised NPAT (%)	-27.5	-35.3	>100	-14.4	3.5	EBITDA margin (%)	9.5	16.9	18.8	17.5	17.2	
Normalised EPS (%)	-27.5	-35.3	>100	-14.4	3.5	EBIT margin (%)	6.1	6.1	9.3	8.2	8.2	
Ordinary DPS (%)	-20.0	-62.5	>100	0.0	11.1	Capex to sales (%)	2.7	3.4	3.8	4.3	4.2	
Cash Flow (NZ\$m)							2019A	2020A	2021E	2022E	2023E	
EBITDA	54.0	86.8	99.0	91.0	92.0	Capex to depreciation (%)	81	31	40	46	47	
Working capital change	(7.4)	22.0	(2.2)	(0.8)	(2.7)	Imputation (%)	100	100	80	80	80	
Interest & tax paid	(7.6)	(6.2)	(26.7)	(24.7)	(25.2)	Pay-out ratio (%)	67	39	57	67	72	
Other	0	(18.9)	0	0	0	Operating Performance						
Operating cash flow	39.0	83.7	70.1	65.6	64.1	Divisional revenue (A\$m)						
Capital expenditure	(15.7)	(17.2)	(20.0)	(22.5)	(22.5)	New Zealand	113.0	101.3	102.8	104.0	106.3	
(Acquisitions)/divestments	0	0	0	0	0	Australia	313.6	266.6	279.3	285.0	292.1	
Other	0	(35.5)	(23.8)	(23.8)	(24.1)	Canada	140.4	123.0	128.7	129.1	134.1	
Funding available/(required)	23.3	31.0	26.3	19.3	17.5	Other	4.1	21.7	14.6	1.6	1.6	
Dividends paid	(19.4)	(5.8)	(17.4)	(17.4)	(19.4)	Total revenue	571.1	512.6	525.3	519.7	534.0	
Equity raised/(returned)	0	0	0	0	0	Divisional EBIT (A\$m)						
(Increase)/decrease in net debt	3.9	25.2	8.9	1.8	(1.9)	New Zealand	22.7	20.0	21.9	21.2	21.4	
Balance Sheet (NZ\$m)							2019A	2020A	2021E	2022E	2023E	
Working capital	131.8	112.9	136.9	139.0	143.0	Australia	32.9	27.4	33.7	32.4	33.4	
Fixed assets	63.2	45.4	45.6	48.5	51.1	Canada	10.2	(2.6)	7.3	7.9	9.3	
Intangibles	15.4	24.4	24.4	24.4	24.4	Corporate and other	(31.3)	(13.6)	(14.1)	(19.0)	(20.2)	
Right of use asset	0	123.9	118.4	113.1	113.1	Total EBIT	34.6	31.2	48.9	42.5	43.8	
Other assets	83.5	92.9	84.9	82.9	80.9	Store numbers						
Total funds employed	293.9	399.5	410.3	408.0	412.5	New Zealand	52	49	49	49	49	
Net debt/(cash)	24.8	(0.5)	(9.4)	(11.2)	(9.3)	Australia	168	155	154	154	154	
Lease liability	0	115.8	116.9	116.7	120.8	Canada	86	86	86	86	86	
Other liabilities	92.4	88.3	81.3	81.3	81.3							
Shareholder's funds	176.8	196.0	221.5	221.2	219.8							
Minority interests	0	0	0	0	0							
Total funding sources	293.9	399.5	410.3	408.0	412.5							

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

Forecast changes

We lift our FY21E EBIT forecast +28% to A\$49m on the back of strong sales and positive margin commentary. We also lift our medium term earnings +12% to +8% as we factor in higher gross margin assumptions.

We expect MHJ to report a meaningful net cash position at 1H21, with strong earnings and improved working capital management. We expect MHJ to reinstate its dividend at the interim result and lift our full year dividend assumption +80% to 4.5cps.

Figure 1. Earnings changes (A\$m)

	FY21E			FY22E			FY23E		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Sales Revenue	518.4	525.3	1.3%	524.9	519.7	-1.0%	537.8	534.0	-0.7%
EBIT	38.2	48.9	28.0%	38.0	42.5	11.8%	40.7	43.8	7.8%
Normalised Profit	22.5	30.3	34.7%	22.5	26.3	16.9%	24.3	27.4	12.7%
Underlying EPS	5.8	7.8	34.7%	5.8	6.8	16.9%	6.3	7.1	12.7%
DPS (AUD)	2.5	4.5	80.0%	3.5	4.5	28.6%	4.0	5.0	25.0%

Source: Forsyth Barr analysis

Figure 2. Price performance



Source: Forsyth Barr analysis

Figure 3. Substantial shareholders

Shareholder	Latest Holding
Hoglett Hamlett Limited	38.3%
Spheria Asset Management	8.7%
ACC	7.4%

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

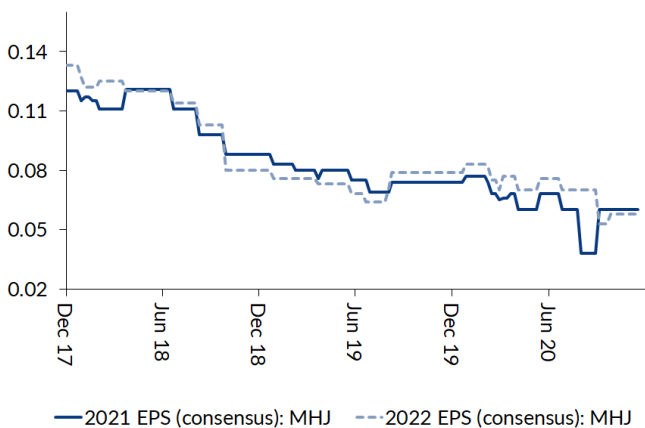
Figure 4. International valuation comparisons

Company	Code	Price	Mkt Cap (m)	PE		EV/EBITDA		EV/EBIT		Cash Yld
				2021E	2022E	2021E	2022E	2021E	2022E	
Michael Hill Intl	MHJ NZ	NZ\$0.63	NZ\$241	7.4x	8.5x	2.2x	2.4x	4.5x	5.2x	7.8%
SIGNET JEWELERS	SIG US	US\$29.62	US\$1,550	39.2x	10.0x	12.4x	7.6x	58.0x	n/a	0.0%
LOVISA HOLDINGS	LOV AT	A\$11.07	A\$1,190	>50x	31.2x	18.8x	12.2x	42.8x	22.5x	2.2%
MYER HOLDINGS	MYR AT	A\$0.35	A\$287	<0x	17.4x	8.1x	7.1x	24.7x	18.8x	0.0%
TIFFANY & CO	TIF US	US\$131.26	US\$15,936	42.4x	29.0x	22.7x	17.3x	39.7x	24.2x	1.8%
KATHMANDU HOLDINGS *	KMD NZ	NZ\$1.31	NZ\$929	20.3x	12.3x	4.9x	4.1x	13.3x	8.5x	5.2%
BRISCOE GROUP *	BGP NZ	NZ\$4.47	NZ\$994	15.8x	16.5x	7.3x	7.5x	9.3x	9.7x	5.0%
THE WAREHOUSE GROUP *	WHS NZ	NZ\$2.60	NZ\$902	12.5x	11.4x	2.6x	2.5x	5.8x	5.0x	6.5%
Compco Average:				26.1x	18.3x	11.0x	8.3x	27.7x	14.8x	2.9%
MHJ Relative:				-72%	-53%	-80%	-71%	-84%	-65%	166%

EV = Current Market Cap + Actual Net Debt

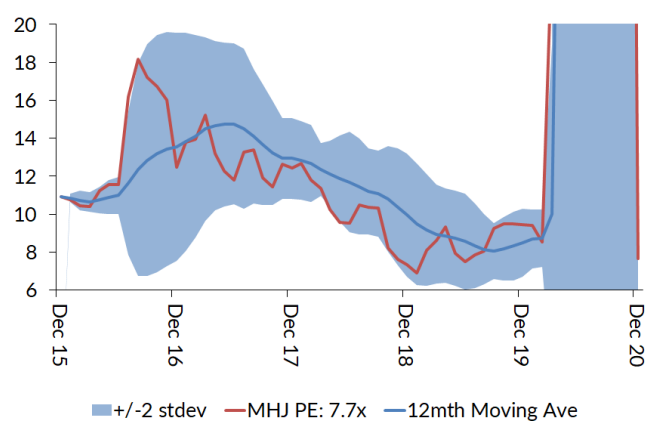
Source: *Forsyth Barr analysis, Bloomberg Consensus, Compco metrics re-weighted to reflect headline (MHJ) companies fiscal year end

Figure 5. Consensus EPS momentum (NZ\$)



Source: Forsyth Barr analysis

Figure 6. One year forward PE (x)



Source: Forsyth Barr analysis

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