

Michael Hill Intl

1H21 — Refined Approach Delivers Shine

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OUTPERFORM

Michael Hill (MHJ) produced a solid 1H21 result, with positive same store sales (SSS) growth and gross margin expansion in all geographies providing us with confidence in its strategic direction and execution. MHJ delivered EBIT of A\$59m at the top end of the A\$56–\$60m guidance. With borders closed and customers reallocating spending towards discretionary purchases, we believe that trading conditions will remain supportive of continued sales growth, especially as retailers cycle initial lockdowns. MHJ signalled a strong start to the period, with same store sales (SSS) up +11% in the first eight weeks of 2H21. We retain our OUTPERFORM rating with MHJ trading on undemanding multiples and further operational improvements, providing upside to our forecasts.

NZX Code	MHJ	Financials: Jun/	20A	21E	22E	23E	Valuation (x)	20A	21E	22E	23E
Share price	NZ\$0.77	NPAT* (NZ\$m)	27.0	37.7	31.5	31.9	PE	10.9	7.8	9.4	9.2
Target price	NZ\$0.87	EPS* (NZc)	7.1	9.9	8.2	8.3	EV/EBIT	11.2	7.0	8.3	8.2
Risk rating	High	EPS growth* (%)	11.5	39.4	-16.5	1.4	EV/EBITDA	4.0	3.7	4.1	4.1
Issued shares	382.5m	DPS (NZc)	1.6	6.3	4.9	5.5	Price / NTA	1.6	1.6	1.5	1.5
Market cap	NZ\$295m	Imputation (%)	100	80	80	80	Cash div yld (%)	2.1	8.2	6.4	7.1
Avg daily turnover	375.2k (NZ\$166k)	*Based on normalised profits					Gross div yld (%)	2.9	10.8	8.4	9.4

What's changed?

- **Earnings:** We lift our FY21 EBIT +13% to A\$74m, reflecting operating leverage and higher margin assumptions. We also make positive gross margin revisions to FY22 and FY23, driving our EBIT forecasts +4% and +1% higher respectively.
- **Target price:** Lifted +7cps to A\$0.87 on the back of earnings changes and higher peer multiples.

Key points of interest

- **Margin expansion the highlight** — Group gross margin expansion of +100bps was a key positive of the result, reflecting ongoing operational improvements and a change in channel and product mix. EBIT margin improved, due to lower SG&A costs, but included A\$17m of wage support. Key strategic highlights included:
 - **Increasing digital sales** — MHJ experienced a leap in online sales penetration (up 3ppts to 5.8% of total sales). The online channel typically delivers gross margins +200–300bps higher than in-store sales.
 - **A step up in loyalty membership** — The 'Brilliance by Michael Hill' loyalty program has quickly amassed 480k members (+237% in 1H21). Sales through the programme are higher margin than historical group sales, and already make up c.60% of total sales.
- **Large net-cash position** — MHJ reported a net-cash position of A\$90m. Contributing to this was the continued unwind of inventory (down c.A\$30m) and an increase in payables due to better creditor terms. MHJ had pre-signalled its desire to rationalise its product range and lower its inventory, and we believe current levels are likely to represent a new normal.
 - MHJ's 1H21 cash balance is artificially high (albeit still very healthy) in our view, with it still to pay its catch up 1H20 dividend (A\$5.8m, announced January 2021) and still to settle its holiday pay liability (c.A\$20m).
- **Interim dividend** — MHJ announced a 1.5cps interim dividend, slightly behind our 2.0cps expectation. The flat dividend reflects an element of ongoing COVID-19 caution around trading disruption, however, we see scope for a higher final dividend (FY21E final 3.0cps) given earnings strength and balance sheet capacity.

Michael Hill International Ltd (MHJ)

Priced as at 24 Feb 2021 (NZ\$) **0.77**

12-month target price (NZ\$)*	0.87
Expected share price return	13.0%
Net dividend yield	7.0%
Estimated 12-month return	20.0%

Key WACC assumptions	
Risk free rate	2.30%
Equity beta	1.15
WACC	7.8%
Terminal growth	1.5%

Spot valuations (NZ\$)	
1. DCF	0.88
2. Sum of the parts	0.73
3. n/a	n/a

DCF valuation summary (NZ\$m)	
Total firm value	770
(Net debt)/cash	1
Less: Capitalised operating leases	432
Value of equity	338

Profit and Loss Account (A\$m)	2019A	2020A	2021E	2022E	2023E	Valuation Ratios	2019A	2020A	2021E	2022E	2023E
Sales revenue	571.1	512.6	535.7	523.8	533.2	EV/EBITDA (x)	0.1	0.0	0.1	0.2	0.2
Normalised EBITDA	54.0	86.8	107.0	96.8	96.3	EV/EBIT (x)	0.1	0.0	0.2	0.4	0.4
Depreciation and amortisation	(19.4)	(55.6)	(50.1)	(48.6)	(48.2)	PE (x)	12.1	10.9	7.8	9.4	9.2
Normalised EBIT	34.6	31.2	73.9	48.3	48.1	Price/NTA (x)	1.7	1.6	1.6	1.5	1.5
Net interest	(2.5)	(9.6)	(9.2)	(9.3)	(9.0)	Free cash flow yield (%)	7.9	22.6	18.0	17.5	15.4
Associate income	0	0	0	0	0	Net dividend yield (%)	5.5	2.1	8.2	6.4	7.1
Tax	(2.3)	(1.4)	(12.6)	(10.1)	(10.1)	Gross dividend yield (%)	5.5	2.1	8.2	6.4	7.1
Minority interests	0	0	0	0	0						
Normalised NPAT	22.8	(8.6)	52.1	28.9	29.0	Capital Structure	2019A	2020A	2021E	2022E	2023E
Abnormals/other	(13.3)	0	0	0	0	Interest cover EBIT (x)	14.0	3.3	6.2	5.2	5.3
Reported NPAT	16.5	3.1	52.1	28.9	29.0	Interest cover EBITDA (x)	21.9	9.1	11.7	10.4	10.7
Normalised EPS (cps)	5.9	(2.2)	13.4	7.4	7.5	Net debt/ND+E (%)	12.3	-0.3	6.3	1.6	0.7
DPS (cps)	4.0	1.5	6.0	4.5	5.0	Net debt/EBITDA (x)	0.5	n/a	0.1	0.0	0.0
Growth Rates	2019A	2020A	2021E	2022E	2023E	Key Ratios	2019A	2020A	2021E	2022E	2023E
Revenue (%)	-5.5	-10.2	4.5	-2.2	1.8	Return on assets (%)	9.1	6.2	15.6	10.4	10.2
EBITDA (%)	-10.4	60.9	23.2	-9.5	-0.6	Return on equity (%)	16.9	13.1	32.9	17.9	17.9
EBIT (%)	-13.7	-9.7	>100	-34.7	-0.4	Return on funds employed (%)	15.7	16.5	32.8	22.3	25.5
Normalised NPAT (%)	-27.5	n/a	n/a	-44.6	0.3	EBITDA margin (%)	9.5	16.9	20.0	18.5	18.1
Normalised EPS (%)	-27.5	n/a	n/a	-44.6	0.3	EBIT margin (%)	6.1	6.1	13.8	9.2	9.0
Ordinary DPS (%)	-20.0	-62.5	>100	0.0	11.1	Capex to sales (%)	2.7	3.4	3.7	4.3	4.2
						Capex to depreciation (%)	81	31	40	46	47
						Imputation (%)	100	100	80	80	80
						Pay-out ratio (%)	67	22	64	60	66
Cash Flow (NZ\$m)	2019A	2020A	2021E	2022E	2023E	Operating Performance	2019A	2020A	2021E	2022E	2023E
EBITDA	54.0	86.8	107.0	96.8	96.3	Divisional revenue (A\$m)					
Working capital change	(7.4)	22.0	(4.3)	4.5	(1.2)	New Zealand	113.0	101.3	107.9	104.2	105.8
Interest & tax paid	(7.6)	(6.2)	(29.7)	(27.3)	(27.1)	Australia	313.6	266.6	297.5	288.9	291.8
Other	0	(18.9)	0	0	0	Canada	140.4	123.0	128.7	129.1	134.1
Operating cash flow	39.0	83.7	72.9	74.0	67.9	Other	4.1	21.7	1.6	1.6	1.6
Capital expenditure	(15.7)	(17.2)	(20.0)	(22.5)	(22.5)	Total revenue	571.1	512.6	535.7	523.8	533.2
(Acquisitions)/divestments	0	0	0	0	0						
Other	0	(35.5)	(43.8)	(23.8)	(24.1)	Divisional EBIT (A\$m)					
Funding available/(required)	23.3	31.0	9.2	27.6	21.3	New Zealand	22.7	20.0	24.8	21.1	21.1
Dividends paid	(19.4)	(5.8)	(23.2)	(17.4)	(19.4)	Australia	32.9	27.4	42.9	37.3	37.5
Equity raised/(returned)	0	0	0	0	0	Canada	10.2	(2.6)	8.3	8.9	9.6
(Increase)/decrease in net debt	3.9	25.2	(14.1)	10.2	1.9	Corporate and other	(31.3)	(13.6)	(2.1)	(19.0)	(20.2)
						Total EBIT	34.6	31.2	73.9	48.3	48.1
Balance Sheet (NZ\$m)	2019A	2020A	2021E	2022E	2023E	Store numbers					
Working capital	133.2	114.3	140.5	137.3	139.8	New Zealand	52	49	49	49	49
Fixed assets	63.2	45.4	45.6	48.5	51.1	Australia	168	155	154	154	154
Intangibles	15.4	24.4	24.4	24.4	24.4	Canada	86	86	86	86	86
Right of use asset	0	123.9	118.4	113.1	113.1						
Other assets	83.5	92.9	84.9	82.9	80.9						
Total funds employed	295.3	401.0	413.9	406.3	409.4						
Net debt/(cash)	24.8	(0.5)	13.6	3.4	1.5						
Lease liability	0	115.8	116.9	116.7	120.8						
Other liabilities	93.7	89.7	82.7	82.7	82.7						
Shareholder's funds	176.8	153.8	158.5	161.3	162.2						
Minority interests	0	0	0	0	0						
Total funding sources	295.3	358.8	371.7	364.1	367.2						

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

1H21 result summary

Divisional detail

- **New Zealand:** SSS increased +3.6% to A\$68.4m, while total segment revenue declined marginally due to temporary store closures in Auckland. Gross margins lifted +230bps to 61.1%.
- **Australia:** SSS increased by +12% to A\$174.2m, with total segment revenue lifting +0.5% despite 2,567 lost trading days due to lockdowns. Gross margins lifted +150bps to 61.4%.
- **Canada:** SSS increased by +3.6% to A\$70.3m, while total segment revenue fell -5.9% due to store closures. Only 40 of 86 stores were trading at balance date. Gross margins lifted +330bps to 61.5%.

Figure 1. 1H21 result summary (A\$m)

	1H20	1H21	% chg	Comments
Sales Revenue	329.5	319.9	-2.9%	Store count down -15, and COVID-19 impacted trading days
Cost of Sales	(126.0)	(119.4)	-5.3%	Better purchasing more than offsetting increasing gold price
Gross Profit	203.4	200.5	-1.5%	Gross margin expansion from less discounting and change in mix
Other Income	0.7	18.0	n/m	One-off wage subsidy boost of A\$17m
SG&A Costs	(141.7)	(133.9)	-5.5%	Lower due to less customers buying on finance, and lower store opex during store closures
Total EBITDA	62.5	84.5	+35.3%	EBITDA margin of 26.4%
Depreciation & Amort.	(27.2)	(25.7)	-5.7%	
EBIT	35.3	58.9	+66.9%	EBIT at top end of a\$56m-60m guidance range
Net Interest	(5.0)	(3.8)	-24.6%	
Profit Before Tax	30.3	55.1	+82.0%	
Tax	(8.9)	(16.1)	+81.6%	Effective tax rate of 29.3%
NPAT	21.4	39.0	+82.1%	
EPS	5.5c	10.1c	+82.1%	
DPS (AUD)	1.5c	1.5c	-	Lower than expected, although scope for catch up at full year

Source: Forsyth Barr analysis, Company reports

Earnings changes and investment view

We lift FY21E EBIT +13% to A\$74m, reflecting higher wage subsidy contribution (+A\$2m), higher gross margin assumptions, and continued consumer momentum contributing to operating leverage. MHJ's 1H21 result demonstrated execution on initiatives to drive improved gross margin, providing confidence and as such we make small positive revisions to our gross margin assumptions.

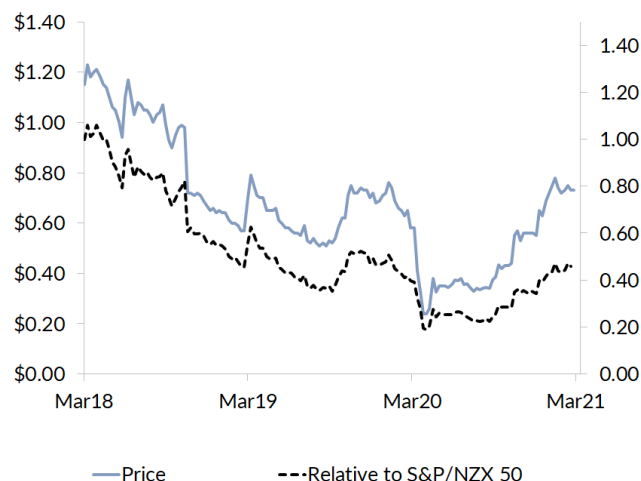
Figure 2. Earnings changes (A\$m)

	FY21E			FY22E			FY23E		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Sales Revenue	526.1	535.7	1.8%	522.3	523.8	0.3%	533.0	533.2	0.0%
EBIT	65.3	73.9	13.2%	46.4	48.3	4.0%	47.7	48.1	0.7%
Normalised Profit	45.4	52.1	14.8%	27.4	28.9	5.5%	28.4	29.0	2.0%
Underlying EPS	11.7	13.4	14.8%	7.1	7.4	5.5%	7.3	7.5	2.0%
DPS (AUD)	6.0	6.0	-	4.5	4.5	-	5.0	5.0	-

Source: Forsyth Barr analysis

Target price increases +7cps to NZ\$0.87; OUTPERFORM

We lift our target price +7cps to NZ\$0.87, reflecting a combination of earnings revisions and peer multiple expansion, more than offsetting changes to our cost of capital assumptions. Our WACC estimate has increased from 7.6% to 7.8% following changes to our risk free rate (from 1.3% to 2.3%) and market risk premium (from 6.0% to 5.5%), consistent with our strategy report, *Still a One Way Bet?* – Updated WACC Assumptions, published 12 February 2021.

Figure 3. Price performance


Source: Forsyth Barr analysis

Figure 4. Substantial shareholders

Shareholder	Latest Holding
Hoglett Hamlett Limited	38.3%
Spheria Asset Management	9.9%
ACC	7.4%

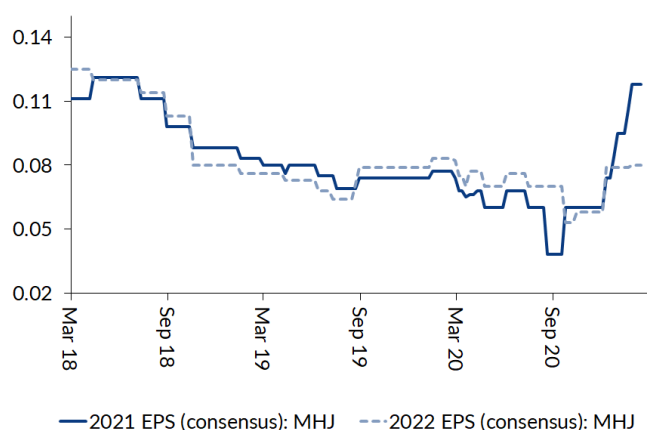
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 5. International valuation comparisons

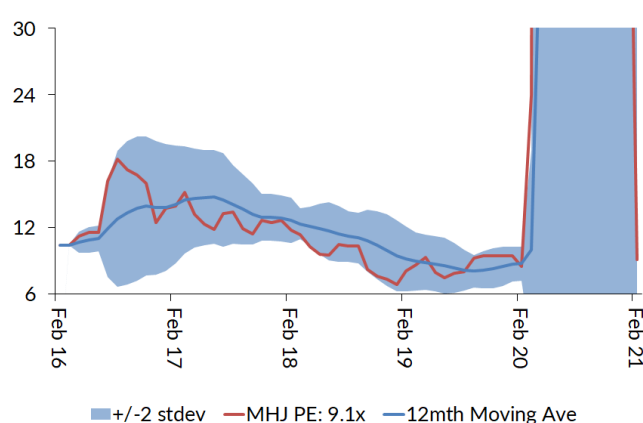
Company	Code	Price	Mkt Cap (m)	PE 2021E	PE 2022E	EV/EBITDA 2021E	EV/EBITDA 2022E	EV/EBIT 2021E	EV/EBIT 2022E	Cash Yld 2022E
(metrics re-weighted to reflect MHJ's balance date - June)										
Michael Hill Intl	MHJ NZ	NZ\$0.77	NZ\$295	7.8x	9.4x	2.6x	2.8x	4.8x	5.6x	6.4%
SIGNET JEWELERS	SIG US	US\$49.05	US\$2,567	25.9x	12.5x	11.0x	8.3x	22.3x	n/a	0.0%
LOVISA HOLDINGS	LOV AT	A\$15.50	A\$1,666	>50x	37.1x	21.4x	15.2x	43.1x	26.4x	2.0%
MYER HOLDINGS	MYR AT	A\$0.31	A\$255	20.2x	15.4x	6.4x	6.0x	13.3x	17.3x	0.0%
TIFFANY & CO	TIF US	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a	n/a
KATHMANDU HOLDINGS *	KMD NZ	NZ\$1.29	NZ\$915	20.0x	12.2x	4.8x	4.0x	13.1x	8.4x	5.2%
BRISCOE GROUP *	BGP NZ	NZ\$5.80	NZ\$1,290	17.6x	17.5x	8.7x	8.6x	10.7x	10.7x	4.3%
THE WAREHOUSE GROUP *	WHS NZ	NZ\$3.24	NZ\$1,124	9.0x	12.1x	2.7x	3.0x	4.9x	5.8x	5.7%
Compco Average:				18.5x	17.8x	9.2x	7.5x	17.9x	13.7x	2.9%
MHJ Relative:				-58%	-47%	-72%	-63%	-73%	-59%	122%

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 6. Consensus EPS momentum (NZ\$)


Source: Forsyth Barr analysis

Figure 7. One year forward PE (x)


Source: Forsyth Barr analysis

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