

Michael Hill Intl

FY20 Result — A Diamond in the Rough?

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OUTPERFORM

Michael Hill (MHJ) reported FY20 EBIT ahead of our expectations, displaying execution on cost out measures and supported by wage subsidy payments. Recent trading suggests MHJ is tracking well into FY21, and we have made positive revisions to our earnings forecasts. We lift our target price +NZ\$0.09 to NZ\$0.49 (+23%), reflecting both higher earnings forecasts and lower cost of capital assumptions. MHJ has shown early signs of positive trading, with scope to beat our forecasts should these continue. However, there is a high degree of uncertainty in near-term outcomes, with the impact of economic fall out from COVID-19 largely unknown. Increases in COVID-19 case numbers and subsequent lockdowns in Victoria and Auckland highlight an ongoing risk for the global retail sector. Trading on a one and two year forward PE ratio of 6x and offering a double digit cash yield in FY22, we view valuation as attractive and more than compensating for uncertainty. We upgrade to OUTPERFORM but note the high risk rating for MHJ.

NZX Code	MHJ	Financials: Jun/	20A	21E	22E	23E	Valuation (x)	20A	21E	22E	23E
Share price	NZ\$0.34	NPAT* (NZ\$m)	-2.5	22.1	23.7	26.5	EV/EBITDA	1.9	1.4	1.5	1.4
Target price	NZ\$0.49	EPS* (NZc)	-0.7	5.8	6.2	6.9	EV/EBIT	9.6	3.4	3.3	3.0
Risk rating	High	EPS growth* (%)	n/a	n/a	6.9	12.1	PE	n/a	5.9	5.5	4.9
Issued shares	382.5m	DPS (NZc)	1.6	2.7	3.8	4.5	Price / NTA	1.0	0.9	0.9	0.9
Market cap	NZ\$130m	Imputation (%)	100	80	80	80	Cash div yld (%)	4.6	8.0	11.1	13.2
Avg daily turnover	254.2k (NZ\$114k)	*Based on normalised profits					Gross div yld (%)	6.5	10.4	14.6	17.3

FY20 characterised by COVID disruption

FY20 was a challenging period for MHJ, with COVID-19 shutting store doors across all markets for up to 13 weeks, resulting in c. A\$80m in lost sales. In addition, foreign exchange headwinds weighed on store gross margin, contracting to 60.6% (from 62.0% in FY19). Supporting earnings was A\$18m of government wage support, as well as execution on cost out initiatives accelerated during the period. Unsurprisingly, digital sales were a bright spot, surging +55% for the year, accelerating meaningfully in 4Q (+240%). Online sales penetration was 5.0% (FY19 2.8%). MHJ has introduced a wide array of digital initiatives, including virtual consultation, a loyalty programme, *Brilliance*, and has recently launched a pure online brand, *Medley*, focussed on the demi-fine jewellery category.

Balance sheet healthy

MHJ has a strong financial position, with a minor net cash position at FY20 year end. Strong cash flows were supported by wage subsidies and a reduction in working capital, driven in part by improved payment terms (expected to be enduring) and rent abatements. After adjusting for rent owed, net debt would increase to ~A\$13m. MHJ has an existing debt facility of A\$70m, providing the company with sufficient capital to support it through both its seasonal peak and possible periods of further disruption.

Strategy update and outlook

MHJ's strategy update maintains a focus on growth and margin expansion, which is expected to be delivered through improving its omni-channel offering, streamlining the supply chain, and embedding cost disciplines. There had been early positive signs of execution on initiatives ahead of COVID-19, and outlook commentary suggests trading out of lockdowns has resumed positively, with sales and gross margin ahead of the prior comparable period. We have made material upgrades to our earnings assumptions, but remain c. -20% below pre-COVID levels, against a share price which has declined -43%. Upgrade to OUTPERFORM.

Michael Hill International Ltd (MHJ)

Priced as at 19 Aug 2020 (NZ\$)

0.34

12-month target price (NZ\$)*

0.49

Expected share price return

44.1%

Net dividend yield

8.5%

Estimated 12-month return

52.6%

Spot valuations (NZ\$)

1. DCF

0.44

2. Sum of the parts

0.48

3. n/a

n/a

Key WACC assumptions

Risk free rate

1.30%

Equity beta

1.21

WACC

7.9%

Terminal growth

1.5%

DCF valuation summary (NZ\$m)

Total firm value

677

(Net debt)/cash

1

Less: Capitalised operating leases

509

Value of equity

169

Profit and Loss Account (A\$m)	2019A	2020A	2021E	2022E	2023E	Valuation Ratios	2019A	2020A	2021E	2022E	2023E
Sales revenue	571.1	512.6	517.8	528.2	539.6	EV/EBITDA (x)	2.8	1.9	1.4	1.5	1.4
Normalised EBITDA	54.0	69.7	85.8	86.7	89.0	EV/EBIT (x)	4.3	9.6	3.4	3.3	3.0
Depreciation and amortisation	(19.4)	(55.6)	(50.1)	(48.6)	(48.2)	PE (x)	4.6	n/a	5.9	5.5	4.9
Normalised EBIT	34.6	14.1	35.7	38.1	40.8	Price/NTA (x)	0.8	1.0	0.9	0.9	0.9
Net interest	(2.3)	(2.0)	(1.0)	(1.3)	(1.3)	Free cash flow yield (%)	17.9	51.1	31.7	27.9	30.7
Associate income	0	0	0	0	0	Net dividend yield (%)	12.5	4.6	8.0	11.1	13.2
Tax	(2.3)	(1.4)	(6.4)	(7.1)	(7.8)	Gross dividend yield (%)	12.5	4.6	8.0	11.1	13.2
Minority interests	0	0	0	0	0						
Normalised NPAT	13.4	14.8	20.5	21.9	23.7	Capital Structure	2019A	2020A	2021E	2022E	2023E
Abnormals/other	3.1	(11.7)	0	0	0	Interest cover EBIT (x)	0.2	0.1	0.2	0.2	0.2
Reported NPAT	16.5	3.1	20.5	21.9	23.7	Interest cover EBITDA (x)	0.1	0.0	0.1	0.1	0.1
Normalised EPS (cps)	3.4	3.8	5.3	5.7	6.1	Net debt/ND+E (%)	100.0	100.0	100.0	100.0	100.0
DPS (cps)	4.0	1.5	2.5	3.5	4.0	Net debt/EBITDA (x)	9.1	2.8	3.0	3.1	3.2
Growth Rates	2019A	2020A	2021E	2022E	2023E	Key Ratios	2019A	2020A	2021E	2022E	2023E
Revenue (%)	-5.5	-10.2	1.0	2.0	2.2	Return on assets (%)	9.1	2.8	7.5	7.9	8.4
EBITDA (%)	-10.4	29.1	23.1	1.0	2.7	Return on equity (%)	17.0	6.9	18.6	19.5	20.8
EBIT (%)	-13.7	-59.3	>100	6.7	7.0	Return on funds employed (%)	15.7	6.7	15.7	17.4	21.3
Normalised NPAT (%)	-57.6	10.5	38.6	7.1	8.2	EBITDA margin (%)	9.5	13.6	16.6	16.4	16.5
Normalised EPS (%)	-57.6	10.5	38.6	7.1	8.2	EBIT margin (%)	6.1	2.7	6.9	7.2	7.6
Ordinary DPS (%)	-20.0	-62.5	66.7	40.0	14.3	Capex to sales (%)	2.7	3.4	3.9	4.3	4.2
						Capex to depreciation (%)	81	31	40	46	47
Cash Flow (NZ\$m)	2019A	2020A	2021E	2022E	2023E	Imputation (%)	100	100	80	80	80
EBITDA	54.0	69.7	85.8	86.7	89.0	Pay-out ratio (%)	57	-239	47	61	65
Working capital change	(7.4)	39.2	3.7	(11.7)	(9.5)						
Interest & tax paid	(7.6)	(6.2)	(15.3)	(16.2)	(17.0)	Operating Performance	2019A	2020A	2021E	2022E	2023E
Other	0	(18.9)	(13.0)	0	0	Divisional revenue (A\$m)					
Operating cash flow	39.0	83.7	61.3	58.8	62.4	New Zealand	113.0	101.3	104.3	107.6	106.2
Capital expenditure	(15.7)	(17.2)	(20.0)	(22.5)	(22.5)	Australia	313.6	266.6	274.0	282.4	288.0
(Acquisitions)/divestments	0	0	0	0	0	Canada	140.4	123.0	128.0	136.7	143.9
Other	0	(35.5)	(38.7)	(23.4)	(23.8)	Other	4.1	21.7	11.6	1.6	1.6
Funding available/(required)	23.3	31.0	2.6	12.8	16.1	Total revenue	571.1	512.6	517.8	528.2	539.6
Dividends paid	(19.4)	(5.8)	(9.7)	(13.6)	(15.5)						
Equity raised/(returned)	0	0	0	0	0	Divisional EBIT (A\$m)					
(Increase)/decrease in net debt	3.9	25.2	(7.1)	(0.7)	0.6	New Zealand	22.7	20.0	20.7	22.2	22.5
						Australia	32.9	27.4	25.6	27.6	28.4
Balance Sheet (NZ\$m)	2019A	2020A	2021E	2022E	2023E	Canada	10.2	-2.6	3.5	7.4	10.1
Working capital	131.8	112.9	123.2	128.4	131.3	Corporate and other	(31.3)	(30.8)	(14.1)	(19.1)	(20.3)
Fixed assets	63.2	45.4	45.6	48.5	51.1	Total EBIT	34.6	14.1	35.7	38.1	40.8
Intangibles	15.4	24.4	24.4	24.4	24.4						
Right of use asset	0	123.9	118.4	113.1	113.1	Store numbers					
Other assets	83.5	92.9	84.9	82.9	80.9	New Zealand	52	49	49	49	49
Total funds employed	293.9	399.5	396.5	397.4	400.8	Australia	168	155	155	155	155
Net debt/(cash)	24.8	(0.5)	6.6	7.3	6.7	Canada	86	86	86	86	86
Lease liability	0	158.0	156.1	156.3	160.8						
Other liabilities	92.4	88.3	81.3	81.3	81.3						
Shareholder's funds	176.8	153.8	152.6	152.4	152.0						
Minority interests	0	0	0	0	0						
Total funding sources	293.9	399.5	396.5	397.4	400.8						

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

FY20 result summary

Michael Hill (MHJ) reported FY20 underlying EBIT (pre-IFRS 16) ahead of our expectations at A\$25.7m (Forsyth Barr A\$18.9m), down -26% on the prior year. Extended periods of store closures across all markets weighed materially on performance, having been tracking for a year on year EBIT improvement at 1H20.

Unsurprisingly, MHJ has decided not to pay a final dividend given the uncertain economic environment. In addition, it has further deferred its AUD 1.5cps 1H20 interim dividend payment until 30 September 2021.

Key take-outs

- **Online sales surged and supported by loyalty programme Brilliance** — Online sales penetration reached 5.0% (FY19 2.8%) as digital sales surged +54.7% for the year, accelerating meaningfully in 4Q (+240%). Canada represented a key area of online sales growth, up +125% on the prior period. Brilliance, MHJ's loyalty programme introduced in October 2019, has grown to 200,000+ members, who deliver both higher average transaction value and gross margin outcomes.
- **Introducing the Medley brand** — MHJ has launched a pure play online brand, Medley, which will be focussed on the demi-fine jewellery category (sub A\$300 price point). This represents a possible, capital light, growth opportunity should MHJ be able to execute, leveraging its learnings from prior forays into the category. At this stage, we do not assume any value to Medley.
- **Strong balance sheet position, year end net cash** — MHJ reported an FY20 net cash position of NZ\$0.6m enabled by strong operating cash flows. A working capital release was in part enabled by improved payment terms with key vendors, which is expected to be an enduring change.
- **Rent deferrals** — Not captured in net debt is rent accrued and not paid during the period. This rental cost (A\$13m) relates to rent incurred through lockdown periods and expected to be paid in FY21, lifting MHJ's underlying debt position.
- **Reducing the store footprint** — MHJ closed 17 stores (13 in Australia and 3 in New Zealand) during FY20. Although this level of footprint reduction was broadly expected, COVID-19 accelerated the time line of closures. We understand rental agreements have been negotiated until post Christmas, with a portion of occupancy costs linked to sales. We, therefore, do not expect to see any further closures over the next six months.
- **Wage subsidies received** — Supporting the FY20 result is government wage support of A\$17.7m (captured in other revenue). Due to the timing of wage subsidies, we understand there is a further c. A\$10m to be received and will be captured in FY21. We do not expect MHJ to be eligible for any wage subsidy extensions.
- **FY21 starting well** — Trading in the first few weeks of FY21 has been solid, achieving both sales growth and gross margin expansion across all markets. Whilst this is encouraging, we note government stimulus measures may be delaying a weaker economic impact and increased case numbers in Victoria and Auckland, highlight the ongoing risk of further lockdowns.

Earnings revisions

We have made material earnings revisions, reflecting 1) a partial reversing of prior downgrades on the back of better than expected retail activity, 2) positive signs of accelerated execution on key initiatives, and 3) incorporation of IFRS 16 accounting for leases. The net IFRS 16 impact on EBIT is c. +A\$6m. Whilst our headline earnings changes are material we note that our current underlying EBIT (pre-IFRS 16) forecasts remain c. -20% below our FY21 pre COVID-19 estimates (26 February 2020).

Figure 1. Earnings changes (A\$m)

	FY21E			FY22E			FY23E		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
Sales Revenue	509.2	517.8	1.7%	530.5	528.2	-0.4%	n/a	539.6	n/a
EBIT	8.2	35.7	+100%	15.3	38.1	+100%	n/a	40.8	n/a
Normalised Profit	3.8	20.5	+100%	8.4	21.9	+100%	n/a	23.7	n/a
Underlying EPS	1.0	5.3	+100%	2.2	5.7	+100%	n/a	6.1	n/a
DPS (AUD)	1.5	2.5	66.7%	2.5	3.5	40.0%	n/a	4.0	n/a

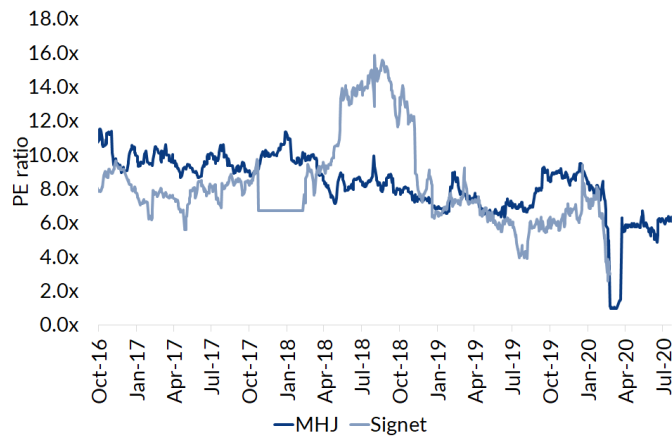
Source: Forsyth Barr analysis

Target price NZ\$0.49; Upgrade to OUTPERFORM on value

Our target price increases +NZ\$0.09 to NZ\$0.49, driven by both changes to forecasts and WACC impacts. Our WACC estimate has fallen from 9.8% to 7.9% following changes to our risk free rate (from 2.0% to 1.3%) and market risk premium (from 7.5% to 6.0%), consistent with our strategy report, *The Cost of Capital Conundrum – When TINA Came to Our Shores*, published 7 August 2020.

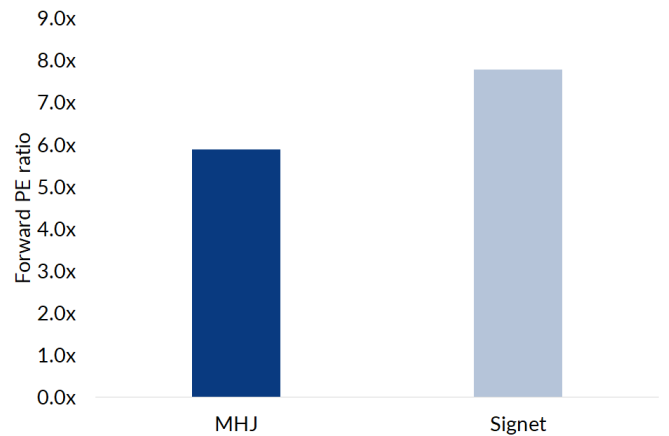
The near term outlook is uncertain, and recent COVID-19 case resurgences and subsequent lockdowns highlight an ongoing risk for the sector. However, MHJ's revised strategy had shown positive signs of execution ahead of COVID-19 and recent trading anecdotes from management are encouraging. Should trading continue at these levels, we see scope for MHJ to beat our forecasts. Despite material upgrades our earnings forecasts remain c. -20% below our pre COVID-19 levels, while the share price was down -43% over the same period (NZ\$0.60 on 26 February). Trading on a 6x PE ratio, MHJ is trading below its historic range (Figure 2) and behind other jewellery companies. We view the risk/reward as attractive and upgrade to OUTPERFORM.

Figure 2. MHJ is trading below its historic range



Source: Bloomberg, Forsyth Barr analysis

Figure 3. Forward PE ratio lagging peer



Source: Bloomberg, Forsyth Barr analysis

FY20 result breakdown

Figure 4. FY20 result breakdown (A\$m)

<u>Profit and Loss Account</u>	FY19	FY20	% chg	Comment
Sales Revenue	569.5	492.1	-13.6%	Adjusted SSS* up +2.7%
Cost of Sales	(214.9)	(173.3)	-19.4%	Both periods include inventory impairments not expected to repeat
Gross Profit	354.6	318.8	-10.1%	Store gross margin contraction (FY20 60.6% vs FY19 62.0%)
SG&A Costs	(300.6)	(249.1)	-17.1%	Wage subsidies ~A\$17.7m, cost out execution, and IFRS16 impacts
Total EBITDA	54.0	69.7	29.1%	EBITDA excluding IFRS 16 of A\$42.5m
Depreciation & Amort.	(19.4)	(38.5)	98.6%	IFRS 16 impact
EBIT	34.6	31.2	-9.7%	Underlying EBIT pre-IFRS 16 \$A25.7m
Net Interest	(2.3)	(9.6)	316.4%	IFRS 16 impact
Profit Before Tax	18.8	4.5	-76.2%	
Tax	(2.3)	(1.4)	-38.3%	Effective tax rate of 32%
Reported Profit	16.5	3.1	-81.5%	
Abnormals	-	-	-	
Normalised Profit	16.5	3.1	-81.5%	
Underlying EPS	4.3	0.8	-81.5%	
DPS (AUD)	4.0	1.5	-62.5%	No final. 1H20 1.5cps interim dividend deferred until 31 September 2021
<u>Balance sheet & cashflow</u>				
Operating Cashflow	39.0	83.7	114.8%	
Fixed Assets	63.2	45.4	-28.2%	Net 16 store closure
Working Capital	164.6	139.3	-15.4%	Inventory management, extended payables terms
Net Debt (cash)	24.8	(0.5)	-102.1%	Working capital release, strong cash flow, delayed rent, and no dividend
Shareholders Equity	176.8	153.8	-13.0%	
Inventory	179.5	178.7	-0.4%	Inventory control
<u>Segment analysis</u>				
New Zealand	113.0	101.3	-10.3%	Adjusted SSS* increased +2.4%, 3 stores closed
Australia	313.6	266.6	-15.0%	Adjusted SSS* increased +0.1%, 13 stores closed
Canada	140.4	123.0	-12.4%	Adjusted SSS* increased +2.3%
Unallocated Sales	2.5	1.1	-	
Total Sales	569.5	492.1	-13.6%	~A\$80m of lost revenue due to COVID restrictions
EBIT - New Zealand	22.7	20.0	-11.9%	
EBIT Margin	20.1%	19.8%	-35bps	
EBIT - Australia	32.9	27.4	-16.7%	
EBIT Margin	10.5%	10.3%	-22bps	
EBIT - Canada	10.2	(2.6)	-125.0%	
EBIT Margin	7.3%	-2.1%	-938bps	
Head office / corporate costs	(31.3)	(19.2)	-38.7%	A\$17.7m of wage subsidy
Total EBIT (ex. IFRS-16)	34.6	25.7	-25.8%	
EBIT Margin	6.1%	5.2%	-86bps	

Source: Company reports, Forsyth Barr analysis, *same store sales adjusted for comparable trading days

Investment Summary

Michael Hill (MHJ) has a renewed focus on its Michael Hill brand following the exit of loss making segments. 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. We view MHJ as trading on attractive multiples, more than compensating for near term risks. **OUTPERFORM.**

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.

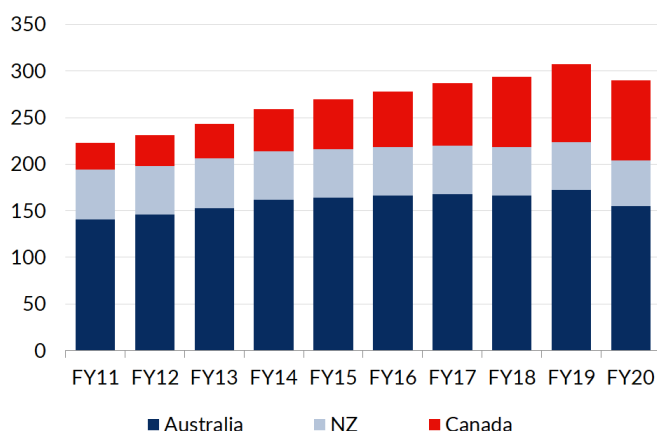
Financial structure

- **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

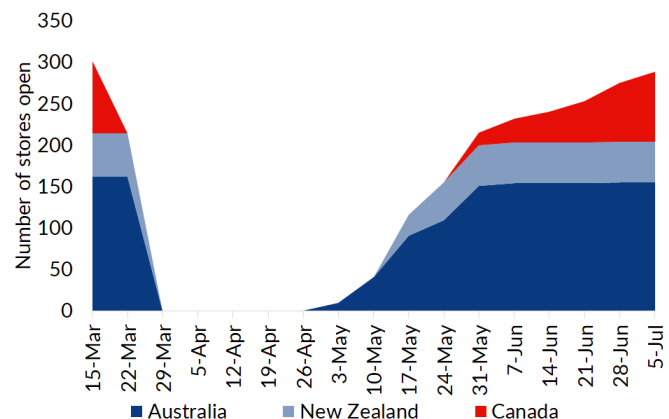
- **Consumer sentiment and retail backdrop:** MHJ's products are reliant on discretionary spending. Jewellery chains that cater to the majority (e.g. MHJ) are typically less affected by economic fluctuations than luxury jewellers.
- **Competitor store closures:** The tough retail backdrop has seen competitor 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

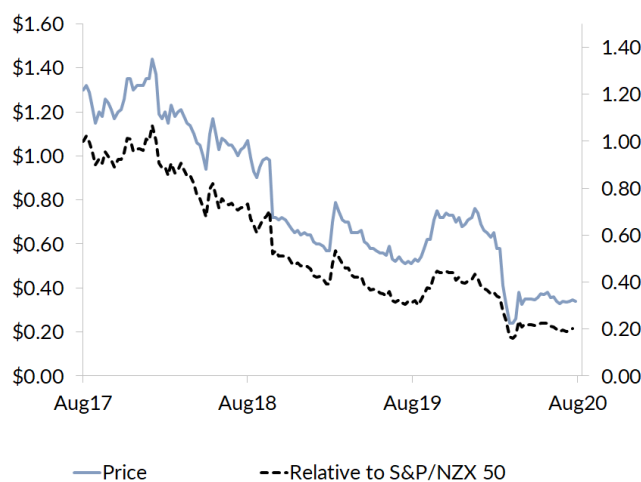


Source: Company reports, Forsyth Barr analysis

Figure 6. Impact of COVID-19 restrictions on MHJ stores open



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%

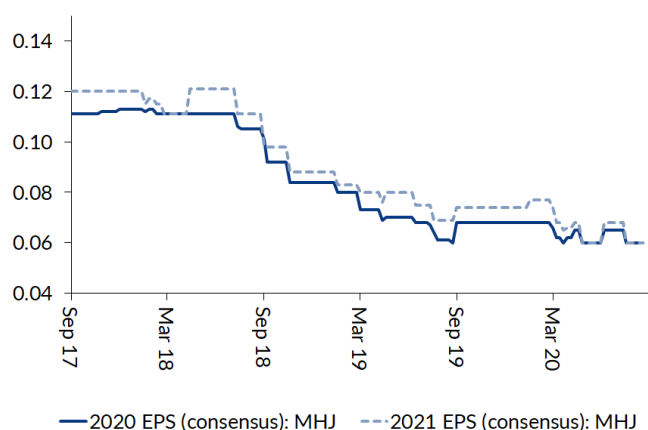
Source: NZX, Forsyth Barr analysis, NOTE: based on SPH notices only

Figure 9. International valuation comparisons

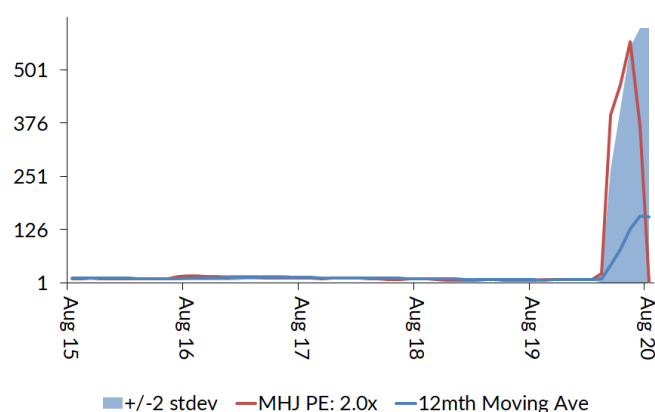
Company	Code	Price	Mkt Cap (m)	PE 2021E	PE 2022E	EV/EBITDA 2021E	EV/EBITDA 2022E	EV/EBIT 2021E	EV/EBIT 2022E	Cash Yld 2022E
(metrics re-weighted to reflect MHJ's balance date - June)										
Michael Hill Intl	MHJ NZ	NZ\$0.34	NZ\$130	5.9x	5.5x	1.4x	1.4x	3.3x	3.1x	11.1%
SIGNET JEWELERS	SIG US	US\$13.49	US\$708	<0x	7.1x	50.8x	n/a	<0x	n/a	0.0%
LOVISA HOLDINGS	LOV AT	A\$7.04	A\$757	35.7x	28.4x	16.1x	13.5x	27.2x	21.5x	2.1%
MYER HOLDINGS	MYR AT	A\$0.21	A\$172	13.3x	6.3x	8.1x	7.3x	22.8x	19.7x	9.0%
TIFFANY & CO	TIF US	US\$127.19	US\$15,433	>50x	32.0x	25.8x	18.4x	38.5x	25.2x	1.8%
KATHMANDU HOLDINGS *	KMD NZ	NZ\$1.17	NZ\$830	18.6x	11.3x	9.3x	6.4x	13.5x	8.2x	5.7%
BRISCOE GROUP *	BGP NZ	NZ\$3.44	NZ\$765	13.4x	13.1x	6.1x	5.8x	7.8x	7.5x	6.4%
THE WAREHOUSE GROUP *	WHS NZ	NZ\$2.03	NZ\$704	19.2x	11.6x	6.6x	5.0x	13.5x	8.4x	6.6%
Compco Average:				20.0x	15.7x	17.5x	9.4x	20.5x	15.1x	4.5%
MHJ Relative:				-71%	-65%	-92%	-85%	-84%	-79%	146%

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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	OUTPERFORM	NEUTRAL	UNDERPERFORM
	43.4%	43.4%	13.2%

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