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Michael Hill International

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MHI

AUD \$1.140

Core

MED.**B**

A diamond in the rough

With kiwi jeweller Michael Hill International (NZX, MHI) preparing to list on the ASX, and having previously traffic lighted the company, we are moving to a buy recommendation on the stock. We are impressed by the quality of management, their international growth strategy and a proven ability in identifying new ways to drive both top and bottom line growth.

We are bullish on the gold price, and so it may seem curious to be recommending a jeweller given this view. However, as was shown during the last bull run in gold, the industry has been successful in passing on higher input costs to customers, with demand being fairly price inelastic. **From a valuation perspective, Michael Hill trades on an undemanding forward multiple of 13.1 times, and has a dividend yield of 5.4 percent** (on a pay-out ratio of only 35 percent). With the firm seeking shareholder approval to list on the ASX we see potential for the company to be positively re-rated as a wider shareholder base increases awareness of the company's plans for growth. Furthermore, a resolution with the IRD on a tax dispute is expected in 2017 and would remove this issue from weighing on the stock.

Accordingly, we are recommending Michael Hill International as a Buy. Australian Members who wish to eliminate exchange rate risk may prefer to wait until the listing occurs on the ASX (scheduled for July) before following this recommendation.



Turning to the charts, the recent break above resistance located at \$1.08 is suggestive of a strengthening of short-term upward momentum. A continued drive north towards the 38.2% Fibonacci retracement of \$1.13 is likely. However, the RSI has moved into overbought territory which is suggestive of an exhaustion of upward momentum. This could lead to a short-term consolidation to unfold over the near term. Positively, once this pause in trend is complete, we would expect the broader term move to be upwards.

The ASX listing

After careful consideration the board has determined that listing on the ASX is in the Brisbane headquartered company's long term best interests, and as such will be seeking shareholder approval to do this. On May 12 the company filed applications with the High Court seeking initial orders in relation to the proposal. If granted, the proposal will be put to shareholders at a special meeting on June 23 and if approved the ASX listing will take place on July 1.

This would see a new Australian Incorporated parent company acquire all the shares in the company on a one for one basis. Following this, the primary listing will be on the ASX but a listing would also be maintained on the NZX. This will simplify its structure with all governance, executive and business operations operating in one jurisdiction.

Over time this is expected to provide the company with direct access to a wider group of investors. The transaction requires approval by 75 percent of the voting shares, but given the sound rationale behind the move and the fact that Michael Hill International is 52.89 percent owned by Michael Hill Family interests (via Durante Holdings), it looks like the decision will easily get over the line.

The Outstanding Tax Dispute

While we restate the investment case below as per the traffic light we issued earlier this month, we also draw attention to the company's dispute with the New Zealand Inland Revenue Department (IRD). Michael Hill management though are confident that they will not have any additional tax to pay, despite settling a claim with the Australian Tax Office (ATO) over the same matter in 2014.

In 2008, after seeking professional tax advice Michael Hill International restructured its business by transferring intellectual property in its retail operations from a NZ subsidiary to an Australian subsidiary. The ATO disputed the company's valuation of the IP at A\$274 million and the value of a deferred tax asset at A\$50.2 million. To settle this dispute, in 2014, Michael Hill International agreed to pay the ATO A\$6 million and as a condition of settlement the ATO accepted the basis for Michael Hill's IP valuation of A\$274 million.

The IRD case however is not as clear-cut, with it looking like the matter will require formal resolution through the courts. The IRD are of the view that the nature of the transaction was a tax avoidance arrangement, and are disputing NZ\$35 million in tax deductions claimed between 2009 and 2014. Michael Hill International asserts that this treatment of the transaction is wrong in law and not tax avoidance. It is interesting to note that management sought approval from both the IRD and ATO prior to implementing this transaction, so for both tax authorities to have an issue with the transaction was unexpected.

The board is challenging the claim in the High Court, and while they remain of the view that this does not require provisioning in the financial statements, they have nonetheless entered into a tax pooling arrangement which will mitigate the risk of an adverse outcome. **Should the decision go against them the quantum of the tax bill could be circa NZ\$40 million.**

We note at FY15 the company had a \$110 million borrowing facility with the ANZ, with \$70 million undrawn, which should underscore the company's funding ability if they have to foot this bill. A favourable outcome however will likely result in a positive rerating of the stock.

The Investment Case

Commencing business with a single shop in Whangarei in 1979, Michael Hill International has grown into a network of over 293 stores spanning 4 countries. The company's philosophy of 'controlled profitable growth' has remained a key theme with the firm recently opening its second store in New York and with the launch of its Emma and Roe brand.

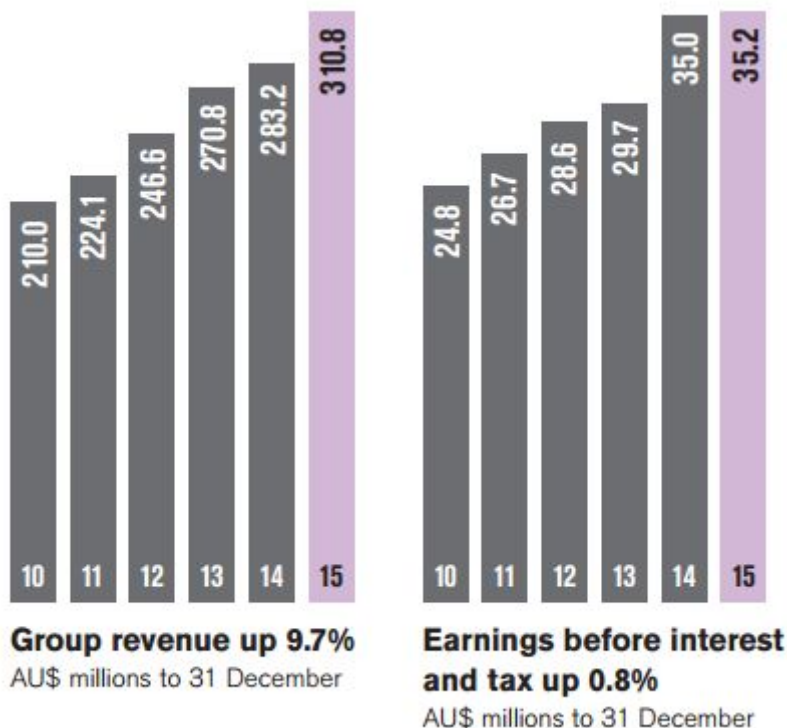
Overall, for the six months to December 31 the Michael Hill group reported a 5 percent increase in NPAT of A\$24.9 million on revenues of A\$310.8 million.

The Australian market constitutes the bulk of the Brisbane Headquartered business' earnings, with 166 stores making up approximately 58 percent of group revenue, or A\$239 million for the nine months to March 31 (NPAT figures are not produced for the nine month period).

The company's expansion into Canada in 2002 is now firmly entrenched, with the significant milestone of having more stores in Canada than in NZ being reached in 2014. While not as profitable as NZ on a same store sales basis, the Canadian market is considerably bigger, providing significantly greater scope for growth. As at December 31 the number of stores in New Zealand stood at 52 and bringing in 20 percent of revenue compared to Canada at 65 stores bringing in 18 percent of revenue.

In addition, Michael Hill has managed to find alternative avenues for growing earnings such as implementing a Professional Care Plan in 2012. The Professional Care Plan can be thought of as insurance for jewellery in that you pay an up-front 'premium' at the time of making a jewellery purchase and in return get access to 'free' repairs and maintenance for your jewellery item over a 3 year or lifetime period. For the six months to December 31 revenue collected from the Professional Care Plan amounted to \$21.7 million, up 8.9 percent on the same period last year.

This incremental growth has been reflected in the Group revenue and EBIT numbers.



Source: Interim Report

Results

In what has been a notoriously tough few years in Australian retail, Michael Hill has managed to keep its head above water, reporting same store sales growth of 3.5 percent in the nine months to 31 March, with the Group achieving same store sales growth of 5.1 percent over the same period, primarily driven by strong growth in NZ and Canada of 6.5 and 5.8 percent respectively.

Michael Hill same store figures in local currency		Last Year	This Year	% Var
Australia same stores	AUD	226,243,020	234,081,372	3.5%
New Zealand same stores	NZD	87,959,386	93,708,949	6.5%
Canada same stores	CAD	56,818,987	60,090,646	5.8%
United States same stores	USD	7,776,565	8,001,865	2.9%
Australia Emma & Roe same stores	AUD	3,150,716	4,407,842	39.9%

Source: Michael Hill Nine Months trading update

The US continues to represent only a small portion of earnings as the company remains committed to testing their business model with its 10 stores. Revenue over the nine months was affected by the temporary closure

of the Woodfield Mall in Chicago for 3 months and costs associated with opening the Roosevelt Fields store in New York.

In addition, Michael Hill has been experimenting with the introduction of a new brand - Emma and Roe - since April 2014. These stores carry unique jewellery collections consisting of bracelets and charms, along with matching jewellery. While this brand is still in test mode the early results have been promising with same store sales growth of 39.9 percent in the nine months to 31 March 2016 or 82.9 percent when including the sales of six new stores opened during that time period.

It is particularly impressive that the Emma and Roe brands now make up more than half of the revenue of the US operations. This highlights another avenue the company has to drive earnings growth.

Same store sales growth is a vital indicator for any retail business, but the fact that additional stores were opened during the period cannot be ignored when looking at the bottom line. While not displayed in a common currency, the below table paints a picture of the positive momentum of the company. With Australia forming the core segment of the company's operations, we are particularly encouraged by the 4.3 percent growth in what has been a tough retail environment.

Michael Hill all stores figures in local currency

Australia all stores	AUD	228,907,516	238,700,793	4.3%
New Zealand all stores	NZD	88,001,759	93,711,873	6.5%
Canada all stores	CAD	60,632,411	72,430,397	19.5%
United States all stores	USD	8,173,292	10,499,389	28.5%
Australia Emma & Roe all stores	AUD	3,430,370	6,274,117	82.9%
New Zealand Emma & Roe all stores	NZD	205,626	545,694	165.4%

Source: Michael Hill Nine Months trading update

Management

We are impressed with the experience and tenure of management, with the results speaking for themselves. Good management is one of the strongest forms of competitive advantage because unlike price and quality it is almost impossible for competitors to imitate. We are encouraged that most of the management team have had a lengthy association with the firm and also have significant stakes in the company, aligning their long term interests with shareholders.

The CEO is Mike Parsell who started with the firm as a watch maker in 1981. Since then he has had experience in all facets of the jewellery industry, spearheading the group's expansion into Australia in 1987.

Sir Michael Hill sits on the Board of Directors as a non-independent director after being Executive Chairman from when the Company listed on the New Zealand stock exchange in 1987 through to December 2015.

While not involved in the day to day running of the business any longer, he is inextricably tied to the company and his extensive business relationship with Mike Parsell would give him some influence over the direction of the company.

When Michael Hill stepped down as Executive Chair in 2015 he was replaced by his daughter, Emma Hill. While on face value it looks like nepotism, on closer inspection Emma had to prove she was worthy of the role, having been knocked back from earlier management positions due to a lack of experience. Emma has

been with the company for over 30 years, is MBA qualified and successfully led the group's expansion into Canada as Retail Manager in 2002.

Value

Michael Hill is currently trading on a forward PE of 13.1 in 2016, with this forecast to drop to 11 in 2017 – this doesn't seem overly demanding for a company experiencing robust global growth. The dividend yield is 5.4 percent this year and forecast to grow to 6.4 percent in 2017. It is worth noting that the pay-out ratio on the dividend declared for the six months ending 31 December, was very low at only 35 percent, with earnings per share coming in at A\$0.065 and a dividend paid of NZ\$0.025. This gives us confidence that the company should easily be able to satisfy its dividend commitments and has the ability to raise its dividend, even with modest earnings growth.

With reference to the weekly chart, prices have respected support at the 61.8% Fibonacci retracement of \$0.89 (blue retracement), which is bullish. Prices have since rotated higher, and in the process, has also broken above the 50-week moving average of \$1.04 signalling a rotation of upward momentum. Over the broader term, resistance is initially expected at the 38.2% Fibonacci retracement of \$1.13 (red retracement), followed by \$1.22. This level is significant as it is made up of the 50% Fibonacci retracement (red retracement) and the 200-week moving average.



Summary

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management, their international growth strategy and a proven ability in identifying new ways to drive both top and bottom line growth.

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Snapshot MHI

Michael Hill International

Latest Closing Price: \$1.140

Michael Hill International (MHJ-NZ, MHJ-ASX) operates a retail jewellery chain of 293 stores in Australia, New Zealand, Canada and USA. MHI employs over 2,400 full and part time staffs and conducts business activities comprising retail sales, manufacturing and administration. Company has two brands the brands Michael Hill and Emma & Roe.

Market Capitalisation: NZ\$437 million

	FY1	FY2

Price to Earnings	11.2	10.6
Dividend Yield (%)	6.3	6.3
Price to Book	2.0	1.9
Return on Equity (%)	18	18
EV/EBITDA	6.3	5.9

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