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Michael Hill International

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Fat Prophets take Profits

International jeweller Michael Hill International (MHJ:ASX, MHJ:NZX) recently provided trading updates that highlight significant changes for the group. The first being a shift into new markets that will lead to growth pains while the company is also exiting a sizable and important market in the US. We have already taken some profits on Michael Hill, banking a 66% gain in the process, and we believe this to be the opportune time to close out the rest of our position.

Recap and Trading Update

The past 18 months has been quite a ride for Michael Hill International, with the company seeing changes at the top, starting with the departure of former Chief Executive Mike Parsell leading to CFO Phil Taylor taking the helm.

We took the opportunity to recommend some profit taking in September 2016 (FAT-AUS-791) at around the \$1.75 level which proved to be prescient as the shares backtracked following a transition of the main listing to the ASX, and with the market then in a consolidation phase. Since then, the company has reported facing headwinds in the fledgling US business and Emma & Roe chain while online threats have disrupted relatively mature operations on Australasia.

Given that, the company has provided updates of write-downs in their newer businesses. Unsurprisingly, the market was clearly disappointed by these revelations leading to the share price tumbling and bottoming at the \$1.03 level in November 2017. Nevertheless, management has made a brave effort in remedying the situation and the appointment of Vanessa Brennan as the company's Chief Customer Officer also helped bolster investor sentiment. This saw the shares recover some lost ground, to now trade at the \$1.27 level.

That aside, the company also provided a trading update on 12 January 2018 which showed a modest operating improvement. The group reported total store sales growth of 4.7% on a year earlier for the six months to 31 December 2017, while same store sales were somewhat flat, up 0.5% over the same period. The same store sales performance continued to face headwinds due to the Emma & Roe chain as well as the US business.

Despite that, management noted that the Emma & Roe business was in an improved position compared to the 1Q given the opening of one new store, bringing the total count to 30. The numbers are summarised in the graphic below.

GROUP SALES

Revenue from the sale of goods and services for the 6 months to 31 December 2017:

The following figures are in Australian dollars	Last Year	This Year	% Var
Michael Hill same stores	308,077,755	310,117,731	0.7%
Emma & Roe same stores	7,638,226	7,228,393	(5.4%)
Total same stores	\$315,715,981	\$317,346,124	0.5%
Michael Hill all stores	317,301,022	331,009,092	4.3%
Emma & Roe all stores	8,748,730	10,505,592	20.1%
Total all stores	\$326,049,752	\$341,514,684	4.7%

Exchange rates used for the 6 months:

New Zealand	1.05	1.09
Canada	0.99	0.98
United States	0.75	0.77

Source: 12 January 2018 Company Filing

Following the trading update, the company announced last week that Emma & Roe was undergoing a "comprehensive brand review" and that management were in the final stages of assessing the 30 store portfolio in conjunction with landlord negotiations. The company also noted a "strategic shift" out into the relatively new "demi-fine" segment which has the appearance of fine jewellery but at lower prices.

Management reports that the reduced store footprint for the Emma & Roe has not yet been determined and it is too early to provide lease liabilities associated with the affected stores. Management expects the non-cash write-downs of Emma & Roe store assets to be circa A\$7 million.

In addition, management have also announced plans to shutter the company's US operations after 10 years of losses, noting that the jewellery markets in the US are highly competitive with far fewer foot traffic in malls (thanks to the Amazon effect) and expensive advertising. The company currently has 9 stores spread out across 3 states.

Management also hasn't provided details on the financial impact of the intended store closures, though they did note that US stores will continue to operate as the company negotiates and completes the exit.

Investors have welcomed the developments with the share price firming of late. The repositioning of Emma & Roe, and US exit will arguably reduce near term earnings drains, while allowing management to refocus on operations in Australia, New Zealand and Canada which around for around 95% of total group revenues. We however note at the same time that the operations (especially Australasia) are relatively mature, and a key long-term growth angle has been removed. The repositioning into the 'demi-fine' segment will also come with its own risks.

Turning to the daily chart, a band of overhead resistance is indicated between \$1.30 and \$1.34. This is made up of the August 2017 high (horizontal dashed-red line) and January intra-month high (horizontal thin-red line) respectively. However, as a result of the stern increase in share price this has resulted in the RSI to venture into overbought territory, and now, to have weakened from this region. Overall, this signals an

exhaustion in short-term upward momentum. Consequently, should the bears maintain downward pressure over the near-term, then this would likely lead to a deeper correction to unfold over the medium-term.



Summary

Michael Hill International recently announced a few key updates that highlight significant changes for the group. First, the company is shifting towards the “demi-fine” segment which will entail additional investment and will come with its own growing pains as management learns to operate in a completely new market segment.

Another shift is the abandoning of the US market which removes a substantial growth avenue given its size (~\$32bn). This is a combination of moves which we believe will put unnecessary pressure on the share price in the medium term.

Given the plethora of opportunities in other share listings, we believe that this is currently the best time for the Members to exit, with the share price at the highest level in 9 months. It also helps that we have already recommended an earlier exit (FAT-AUS-716) at a much higher-level, for a gain then of around 66%.

Accordingly, we recommend Members SELL their Michael Hill shares at current levels and fully exit from the position.

Disclosure: Interests associated with Fat Prophets declare a holding in Michael Hill International.

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Snapshot MHJ

Michael Hill International

Latest Closing Price: \$1.27

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:\$495.92M

	FY1	FY2
Price to Earnings	15.0	12.8
Dividend Yield (%)	4.1	4.2
Price to Book	2.3	2.2
Return on Equity (%)	15.9	17.2

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