ASX Small Caps Stocks Down Under

> *Jewellery is the most transformative thing you can wear.*
>
> - Iris Apfel (b. 1921), Fashion design entrepreneur

MICHAEL HILL

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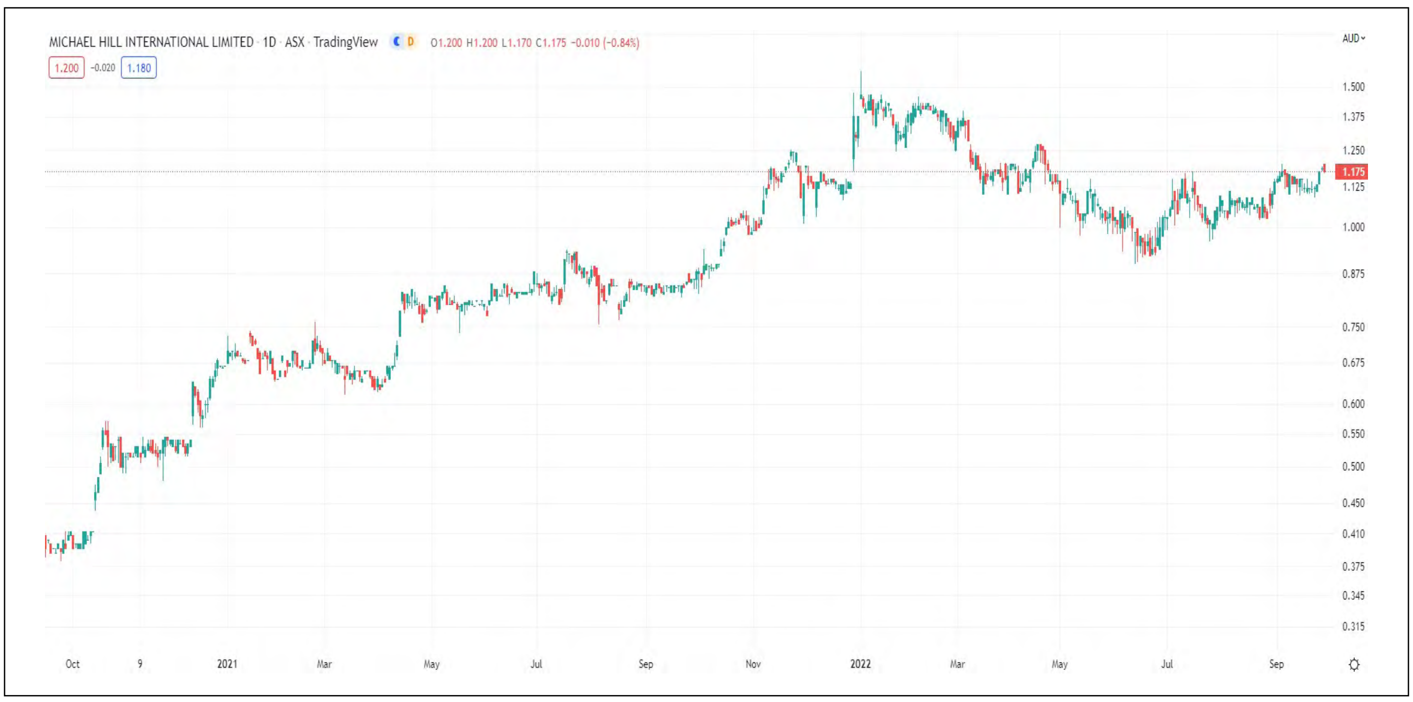
Stocks Down Under rating: ★★

ASX: MHJ
Market cap: A$456M

52-week range: A$0.82 / A$1.57
Share price: A$1.18

In recent weeks, we've paid close attention to niche retailers that we think might be able to withstand the current bout of inflation, which is the highest in 40 years. Notwithstanding that many of these retailers are categorised by the market as 'consumer discretionary', we think some of these companies provide goods that will be harder for consumers to put off even if they have the choice. One reason might be because these are very rare purchases, such as wedding rings. Does this logic ring true with jewelry chain Michael Hill (ASX:MHJ)?

Share price chart



Source: Tradingview

Surviving through multiple eras

Michael Hill was founded in 1979 by Sir Michael Hill, who opened the first store in Whangarei, New Zealand and retains a stake of over 40% in the company today. It now has nearly 300 stores in New Zealand, Australia and Canada. The company listed on the NZX in 1987 and remains there today, but joined the ASX in a dual listing in early 2016. The dual-listing, which raised over $400m at 89c a share and marked the 2nd biggest IPO of the year, was an attempt to draw capital and liquidity that it would have been unable to access back home.

However, the first four years of listing were very difficult for the company as sales and profits fell. The biggest problem with the company's business model was that it mostly sold products designed and made by other companies, which means lower margins than competitors. This was particularly a problem given jewelry tends to be a less frequent purchase. The company also had a minimal presence online.

Turnaround attempts finally bear fruit

Early attempts to turn the company around in these respects were disastrous and made sales fall even further. On top of this, Michael Hill was hit with a legal battle by former staff alleging underpayment. The onset of COVID-19 rubbed salt into the wounds of shareholders, when its stores were forced to close. Given the one-on-one nature of its customer service, following social distancing guidelines was unfeasible. The company's profit fell by over 80% and it estimated that the initial store closures cost it over $80m in sales.

More than two years on, things are looking up for Michael Hill. Over the last four years, it has been headed by former Myer executive Daniel Bracken. He came to the company with a reputation as a turnaround specialist and this is what he has been trying to do. He has been increasing the company's online sales, updating the store network by closing unprofitable stores and refurbishing the old ones and he introduced a loyalty program that now has over 1.4 million members.

A solid FY22

It has only been a month since Michael Hill reported FY22 results and they looked healthy even though they included store closures during the Delta waves. Group operating revenue amounted to $595.2m (up 7%), EBIT was $62.9m (up 11%) and NPAT came in at $46.7m (up 14%).

The group gross margin was 64.7% (200 basis points higher) and the company had a net cash position of $95.8m (up from $72.4m 12 months earlier). The company paid a total dividend of 7.5c per share, a yield of more than 6% at the current share price and unveiled an on-market share buy-back of up to 5% of its total issued capital.

Guidance for FY23 was not provided, but management did provide a trading update for the first eight weeks of FY23. Sales were up 13.4% against the same period in FY21 (FY22 would have been a less meaningful comparison due to store closures at the start of that period).

Consensus estimates suggest sales will grow, but more moderately than is currently the case. Specifically, $599.9m in revenue and $116.8m in EBITDA, up 1% and 2% from FY22. FY24 is forecasted to be similar with $612.9m in revenue and $119.3m in EBITDA, up 2% from FY24.

You can buy Michael Hill for just 4x EV/EBITDA and 9.5x P/E, which both appear cheap. But the fact that it has a 2x EV/EBITDA to EBITDA growth multiple (in other words, its EV/EBITDA is twice its expected growth) makes us reconsider that statement.

Is it the right time to get in?

We think this could be a company for day traders. As we noted in our Insights Article on Michael Hill earlier this month, the company's shares appear to be out of a downtrend and we think the first target for the next share price rally is the previous high of $1.56. Our suggested stop loss is 90c.

Investors looking for an inflation-beating dividend yield may also like this company given what it paid its shareholders for FY22 – a yield greater than 6%. But it has a very flexible dividend payout policy of 50-75% and has hinted at acquisitions, so there's no guarantee it will be repeated.

For longer-term investors looking for growth, we think this is two stars. This is not because we are in denial that jewelry is a retail category that can beat inflation. Primarily, our rating is because we would rather be invested in companies with higher EBITDA growth, such as Lovisa which is expected to see 26% EBITDA growth in FY23 judging by consensus estimates but has an EV/EBITDA to EBITDA growth multiple of just 0.6x considering its EV EBITDA is just 15x.

We also think that while Daniel Bracken has done a good job at turning the company around, he has not gone as far as he arguably could have in increasing online sales and consolidating stores. Other companies, such as Flight Centre (ASX: FLT), have done a better job during the pandemic in this respect. Remember, Michael Hill only generates 7.1% of sales online.

That said, we might rate this company higher next time if we saw further progress being made in those regards or if it was outperforming consensus estimates. Yet with the company moving back to half-yearly reporting, it won't be until the March quarter of next year, when it reports 1HY23 results, that we will be able to tell. So, two stars for the time being.

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