Focusrite

Full-year pre-close statement

Second-half trading as expected with higher cash

Consumer electronics

Focusrite ends the year with revenue as forecast, continued profit growth in the second half and revenue in line with our expected slower second-half growth. Cash of £22.8m is 10% higher than we forecast and is now over half the balance sheet. US tariffs will likely apply to Focusrite's business there and management has been considering its response, while risks associated to Brexit appear relatively minor to us. It seems the share price continues to discount a significant acquisition.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	EV/EBITDA (x)	Yield (%)
08/16	54.3	7.7	11.8	2.0	37.9	24.8	0.4
08/17	66.1	9.5	14.8	2.7	30.2	18.7	0.6
08/18e	75.4	10.8	16.3	3.0	27.4	16.2	0.7
08/19e	80.0	11.5	17.0	3.3	26.3	15.7	0.7

Note: *PBT and EPS are normalised, excluding amortisation of acquired intangibles, exceptional items and share-based payments.

Revenue and trading in line, cash above forecast

Focusrite has indicated that H2 revenue, profits and cash have all continued in y-o-y growth in H2, consistent with our profit and loss forecast. Growth has been broadly based across core product areas and in all major regions. In addition, positive results reported from expansion into new markets indicate a return on recent investment in Asia and potentially Latin America.

Cash: Further strengthens balance sheet

Net cash of £22.8m at August is 10% above our forecast and a net £8.6m rise in the year. As profits are in line, the beat was effectively achieved by continued control over working capital. The added cash may heighten observers' expectations of an acquisition, but the company continues the same stringent screening process.

Macro risks flagged: US and Europe

With some 40% of Focusrite's sales in the US and production in China, the company expects that extended tariffs will be applied to its products in common with its competitors. Management has been planning for this and considering the natural choice between absorbing the impact or passing it on to customers. Depending on Brexit outcomes, sterling could strengthen if a deal is struck, which, subject to the company's hedging arrangements would affect the sterling value of the company's euro sales. In another scenario, customs hold-ups might affect distribution of Focusrite's product, although this should be manageable.

Valuation: No change in our view

On a DCF basis, the share price remains equivalent to a medium-term organic growth rate of about 12%. On a peer group comparison, the picture is mixed: the shares trade at a 2% P/E discount for FY18e but a 30% premium for FY19e. On an EV/EBITDA basis the company trades at a premium of 21% for FY18e and 32% for FY19e. The missing element is the excess cash, where the market appears to be discounting investment of the net cash balance at a c 15% post-tax return.

18 September 2018

Price	**447.50p**
Market cap	**£260m**

Net cash at 31 August 2018 (£m)	22.8
Shares in issue	58.1m
Free float	59%
Code	TUNE
Primary exchange	AIM
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	(2.5)	(5.2)	55.7
Rel (local)	0.3	(1.1)	52.8
52-week high/low		504.0p	257.5p

Business description

Focusrite is a global music and audio products group supplying hardware and software products used by professional and amateur musicians, which enables the high-quality production of music.

Next events

Final results	20 November 2018

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Edison profile page

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Full year pre-close

Revenue and profit: H2 at least equal to our forecast

Focusrite has indicated that H2 revenue, profits and cash have all continued in y-o-y growth. That is consistent with our profit and loss forecast and better than our previously forecast year-end cash of £20.8m.

Exhibit 1: H1/H2 forecast

£000s	H117	H217	FY17	H118	H218e	FY18e	H1 y-o-y	H2 y-o-y	FY y-o-y
Revenue	32,020	34,035	66,055	38,819	36,593	75,412	21.2%	7.5%	14.2%
Gross profit	12,855	13,496	26,351	16,200	15,282	31,482	26.0%	13.2%	19.5%
Gross margin	40.1%	39.7%	39.9%	41.7%	41.8%	41.7%	3.9%	5.3%	4.6%
Adjusted EBITDA	6,131	6,978	13,109	7,969	7,159	15,128	30.0%	2.6%	15.4%
Adjusted EBITDA margin	19.1%	20.5%	19.8%	20.5%	19.6%	20.1%	7.2%	-4.6%	1.1%
Operating profit	4,571	4,899	9,470	6,230	4,994	11,224	36.3%	1.9%	18.5%
Pre-tax profit	4,599	4,913	9,512	5,833	5,004	10,837	26.8%	1.8%	13.9%
EPS (p)	7.0	7.8	14.8	16.3	17.0	17.6	133.2%	117.5%	18.8%
Net cash	9,391	14,174	14,174	19,734	22,881	22,881	110.1%	61.4%	61.4%

Source: Focusrite, Edison Investment Research

Focusrite confirms revenue for the year is c £75m, in line with our expectation of £75.4m. This implies second half sterling-reported growth of 7.5% compared with 21% in H1 to give 14% for the full year. On a constant currency basis, full-year revenue growth of over 15% compared with 26% in H1 implies H2 growth of 4–5%. That is a good level of increase, especially as management indicates it was broadly based across core product areas and in all major regions. In addition, positive results reported from expansion into new markets indicates a return on the recent investment made into the sales regions of Asia and, to a lesser extent, Latin America.

The company does not quantify the level of H2 profit growth, but our pre-tax forecast of 1.8% was deliberately cautious so there could be a further step up to the actual result when reported in November 2018.

The statement also refers to moves, set out at the full year, to structure sales programmes to enhance the lifetime value of customers, which should bring benefits over the medium term.

Cash: Adding further strength to the balance sheet

Focusrite has increased net cash to £22.8m, an £8.6m rise in the year. That is 10% higher than our previous forecast of £20.8m. This was achieved mainly by the value added by increased profits, as well as prudent working capital management. We understand that there is unlikely to be a material reversal of the working capital position post year end. As a result, the balance sheet is even stronger than we previously recognised, with 56% of shareholders' equity in cash.

Potential acquisition activity

Management has made no secret of the fact that it considers acquisitions as a growth vehicle, and we understand that the process of reviewing possible acquisitions remains active. Some candidates offer themselves because the company has excess cash and has expressed an inclination to seek acquisition assets. Others are identified by management as part of a screening process for likely targets that meet its strategic criteria.

Macro factors present potential risk

Management references macroeconomic risks in its statement. These are in two separate areas, the US and Europe:

Macro factors: US

Focusrite's products are sourced from China and c 41% of its sales are into the US. Management expects these to become subject to the latest round of tariffs imposed on imports into the US from China. News reports have suggested an initial 10% level for the tariffs. As the breadth of applicable products has widened, Focusrite has been planning for this and considering the natural choice between absorbing the impact or passing it on to customers. Its competitors in both its main product areas will need to make the same choice.

That said, it is becoming clear that Trump's negotiating style is to create a major threat as a show of power, leading to a strong base that can then be used to make discussions more productive. If this represents such a tactic and it works as intended, the risk could be reduced.

Macro factors: Europe

The major risk factor in Europe is clearly Brexit. It is therefore uncertain precisely how such risks could play out in practice, but the main areas we would focus on are:

- Exchange rate fluctuations: markets to some extent reflect a no-deal scenario and sterling could strengthen if a deal is struck. If this happened, it could impact sterling value of the company's euro sales (c 25% of revenue). We understand the company has hedged c 70% of its FY19 and c 25% of its FY20 exposure.
- Product distribution: the principal risk is that customs hold-ups following some versions of a Brexit deal, or no deal, might affect distribution of Focusrite's product. On the plus side, the company sends its product to distributors, who supply end retailers, so that fine timing is not a major issue. Also, Focusrite uses internationally established freight forwarders who are likely to have the best systems and strategies for avoiding unnecessary delays.

Forecast: No change to profit or earnings

We make no changes to our forecast profit and loss for FY18 or FY19. We reflect year-end net cash of £22.8m as confirmed in the statement. Looking forward, we cautiously assume that £1m of the £2m uplift in that figure rolls forward to FY19.

Valuation: No change in our view

With no change in our earnings forecast, we make no major alterations to our valuation metrics. We value the shares using DCF techniques to evaluate the longer-term income stream available to investors. As a secondary metric, we consider valuation in relation to a peer group of smaller companies on near-term earnings expectations, although few of these are close peers. However, as discussed below, neither metric fully reflects the potential of the company's cash of £22.8m.

DCF valuation: Market is discounting substantial growth

Our DCF projection extends our forecasts out to 10 years with revenue growth fading in the last three years to a terminal rate of 2%. We assume a terminal EBITDA margin of 21% (as 19.8% was already achieved in 2017, this may be conservative) and capex investment at 7% of revenue, reducing to 5% in the terminal period. We assume an equity-only cost of capital of 8.4%.

It remains the case that the current share price is equivalent to a medium-term revenue growth rate of about 12%, well within previously achieved growth rates. Exhibit 2 below shows the share price implication of alternative sales growth rates, as well as terminal margin assumptions.

Exhibit 2: Sensitivity to medium-term growth rate and terminal margin

		Sales growth FY21-25				
		8%	10%	12%	14%	16%
Terminal margin	23.0%	428	461	497	536	577
	22.0%	408	439	473	509	548
	21.0%	387	417	449	483	520
	20.0%	367	395	425	457	491
	19.0%	347	373	401	431	463

Source: Edison Investment Research

Peer group reference: Mixed picture

Focusrite does not have a direct peer, but we compare it with UK smaller-cap tech, electronics and consumer companies in relevant subsectors, as well as relevant companies in US and European markets. This is far from an exact comparison but does give some context in terms of market valuations in adjacent sectors.

Exhibit 3: Peer valuations

	P/E (x)		EV/EBITDA (x)		EV/Sales (x)	
	Yr1e	Yr2e	Yr1e	Yr2e	Yr1e	Yr2e
Universal Electronics	19.5	12.8	9.3	7.1	0.6	
Tivo		11.7	11.8	10.4	3.3	3.3
Morgan Advanced Materials	11.2	12.2	6.9	7.2	1.4	1.3
Photo-Me International	13.6	13.1	6.4	6.2	2.4	2.3
Oxford Instruments	17.3	15.9	10.8	10.2	2.8	2.8
Bang & Olufsen	62.8	23.1	12.2	9.8	0.4	0.4
XP Power	18.4	15.4	13.7	11.7	3.5	3.4
Avid Technology		29.9	10.7	8.8	0.5	
Gooch & Housego	30.1	26.1	17.8	15.6	4.0	3.8
Dialight	24.3	13.6	11.2	7.4	1.1	1.0
Quixant	27.1	24.5	19.7	17.8	3.2	2.8
Judges Scientific	22.0	18.7	13.4	13.3	2.7	2.6
B&C Speakers		16.9		12.2	2.7	2.5
Trakm8 Holdings	8.2		5.1		0.9	
Gear4music Holdings	61.9	42.2	28.3	20.8	1.9	1.4
Average	27.6	20.0	13.2	11.7	2.4	2.6
Focusrite	27.0	25.9	16.0	15.4	3.2	3.0
Premium/(discount)	-2.3%	29.6%	21.2%	32.1%	35.5%	17.2%

Source: Bloomberg. Note: Based on market prices at 17 September 2018.

Focusrite trades on a 2% P/E discount for FY18e but a 30% premium for FY19e. On an EV/EBITDA basis, it trades at a premium of 21% for FY18e and 32% for FY19e. On an EV/sales basis the company also trades at a premium to the peer group.

The cash valuation gap got bigger

While on the face of it our metrics do not point to valuation at or above current market levels, what is left out of the equation is how Focusrite's increased excess cash of £22.8m may be used. Here we consider the likely effect of using it to make an accretive acquisition.

As we analysed in our April note, Focusrite generates high average taxed ROCE rates of 45–51%. It is not likely that the company could generate such returns from an acquisition. However, using a range of lower ROCE rates, the cash would imply additional value as follows:

Exhibit 4: Potential value impact of excess cash (£m/p per share)

ROCE	10%	15%	20%
Excess cash	22.8	22.8	22.8
Post-tax earnings	2.3	3.4	4.6
Incremental EPS	3.9	5.9	7.8
Pro forma FY19 EPS	20.9	22.8	24.8
Peer P/E	20	20	20
Implied share valuation (p)	417	456	495

Source: Edison Investment Research

Hence, it would seem the market appears to be discounting investment of the net cash balance at a c 15% post-tax return.

Exhibit 5: Financial summary

	£000s	2016	2017	2018e	2019e	2020e
31-August		IFRS	IFRS	IFRS	IFRS	IFRS
INCOME STATEMENT						
Revenue		54,301	66,055	75,412	80,022	86,023
Cost of Sales		(33,439)	(39,704)	(43,930)	(46,615)	(50,111)
Gross Profit		20,862	26,351	31,482	33,406	35,912
EBITDA		10,249	13,109	15,128	15,662	16,660
Operating profit (before amort. and except).		7,677	9,470	11,224	11,465	12,183
Amortisation of acquired intangibles		0	0	0	0	0
Exceptionals		(537)	0	0	0	0
Share-based payments		0	0	0	0	0
Reported operating profit		7,140	9,470	11,224	11,465	12,183
Net Interest		(14)	42	(387)	50	50
Joint ventures & associates (post tax)		0	0	0	0	0
Exceptionals		0	0	0	0	0
Profit Before Tax (norm)		7,663	9,512	10,837	11,515	12,233
Profit Before Tax (reported)		7,126	9,512	10,837	11,515	12,233
Reported tax		(870)	(959)	(1,300)	(1,555)	(1,835)
Profit After Tax (norm)		6,793	8,553	9,536	9,961	10,398
Profit After Tax (reported)		6,256	8,553	9,536	9,961	10,398
Minority interests		0	0	0	0	0
Discontinued operations		0	0	0	0	0
Net income (normalised)		6,900	8,553	9,536	9,961	10,398
Net income (reported)		6,256	8,553	9,536	9,961	10,398
Basic average number of shares outstanding (m)		53.2	55.4	56.7	56.7	56.7
EPS - basic normalised (p)		13.0	15.4	16.8	17.6	18.3
EPS - normalised (p)		11.8	14.8	16.3	17.0	17.6
EPS - basic reported (p)		11.8	15.4	16.8	17.6	18.3
Dividend per share (p)		2.0	2.7	3.0	3.3	3.7
Revenue growth (%)		13.1	21.6	14.2	6.1	7.5
Gross Margin (%)		38.4	39.9	41.7	41.7	41.7
EBITDA Margin (%)		18.9	19.8	20.1	19.6	19.4
Normalised Operating Margin		14.1	14.3	14.9	14.3	14.2
BALANCE SHEET			**13,748**	**11,520**	**14,625**	**17,321**
Fixed Assets		6,367	6,332	6,940	8,138	9,462
Intangible Assets		4,792	4,963	5,737	7,107	8,579
Tangible Assets		1,575	1,369	1,203	1,031	883
Investments & other		0	0	0	0	0
Current Assets		28,191	36,126	44,080	51,129	58,282
Stocks		11,361	9,000	9,629	11,047	12,494
Debtors		11,224	12,952	11,570	13,593	15,319
Cash & cash equivalents		5,606	14,174	22,881	26,489	30,470
Other		0	0	0	0	0
Current Liabilities		(9,256)	(8,663)	(9,936)	(10,322)	(10,854)
Creditors		(8,612)	(8,204)	(9,679)	(10,015)	(10,492)
Tax and social security		(644)	(459)	(257)	(307)	(363)
Short term borrowings		0	0	0	0	0
Other		0	0	0	0	0
Long Term Liabilities		(282)	(245)	(287)	(361)	(440)
Long term borrowings		0	0	0	0	0
Other long term liabilities		(282)	(245)	(287)	(361)	(440)
Net Assets		25,020	33,550	40,797	48,585	56,449
Minority interests		0	0	0	0	0
Shareholders' equity		25,020	33,550	40,797	48,585	56,449
CASH FLOW						
Op Cash Flow before WC and tax		10,249	13,109	15,128	15,662	16,660
Working capital		(6,009)	407	1,562	(3,105)	(2,696)
Exceptional & other		(417)	137	(0)	(0)	(0)
Tax		(165)	(633)	(1,300)	(1,555)	(1,835)
Net operating cash flow		3,658	13,020	15,390	11,003	12,128
Capex		(3,675)	(3,614)	(4,594)	(5,557)	(6,095)
Acquisitions/disposals		0	0	0	0	0
Net interest		(111)	(42)	(387)	50	50
Equity financing		172	258	0	0	0
Dividends		(976)	(1,138)	(1,702)	(1,888)	(2,103)
Other		365	84	0	0	0
Net Cash Flow		(567)	8,568	8,707	3,608	3,980
Opening net debt/(cash)		(6,173)	(5,606)	(14,174)	(22,881)	(26,489)
FX		0	0	0	0	0
Other non-cash movements		0	0	0	0	0
Closing net debt/(cash)		(5,606)	(14,174)	(22,881)	(26,489)	(30,470)

Source: Focusrite, Edison Investment Research

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