EDISON

Focusrite

Outstanding first half

Interim results

Consumer electronics

Focusrite has delivered an outstanding first half with substantial growth on all metrics, across all territories and in both product brand groups. Constant currency revenue growth of 26% is double that of FY17 although, after an unprecedented pre-Christmas period, it is possible that the shape of trading may be becoming more seasonal. The company has net cash of c £20m, and the share price appears to discount a return on that.

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	35.6	23.3	0.5
08/17	66.1	9.5	14.8	2.7	28.4	17.5	0.6
08/18e	75.4	10.8	16.3	3.0	25.7	15.2	0.7
08/19e	80.0	11.5	17.0	3.3	24.8	14.7	0.8

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

Interim results: Outstanding growth on all measures

A clean set of H1 results shows consistent and substantial organic growth across the business. Revenue, at £38.8m, beat pre-close guidance of £38.0m, growing by 21.2% y-o-y, with sterling strength masking 26% constant currency revenue growth, twice what it was in FY17. EBITDA grew by 30.0% and operating profit by 36.3%. Operating margin improved from 14.3% to 16.0%, driving 27% growth in pre-tax profit. Net cash has grown since year end by £5.6m to £19.7m.

Impressive trading performance in all categories

Like many much larger companies, Focusrite has a largely international market, with c 85% of revenues outside the UK. Regionally, constant currency growth is in impressive double figures across the board, with the lowest region being 19% in Europe, Africa and the Middle East. Here all the major territories (UK, Germany and mainland Europe) were in solid growth. By division, there has also been consistent growth, with Focusrite division growing revenue at 23% and Novation by 19%.

Forecast upgrade of 5% PBT may be cautious

It is possible that first-half strength may reflect a change in the seasonal shape of sales. In the light of that possibility we carry forward the H1 revenue beat of £0.8m (compared with the March trading statement), resulting in a 4.5% improvement at PBT level for FY18e. We cautiously leave our expectation for H2 effectively unchanged. If our caution is unnecessary, there should be further upside to our FY18 forecast. For FY19e we upgrade our PBT forecast by 3.5%.

Valuation: Cash is the key

On a DCF basis, the current share price is 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 1% P/E discount for FY18e but a 31% premium for FY19e, and an EV/EBITDA premium of 23% for FY18e and 34% for FY19e. The missing element is excess cash, where the market appears to be discounting investment of the net cash balance at a c 15% return.

24 April 2018

Price	**420p**
Market cap	**£244m**

Net cash (£m) at 28 February 2018	19.7
Shares in issue	58.1m
Free float	59%
Code	TUNE
Primary exchange	AIM
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	5.1	20.4	105.8
Rel (local)	1.1	25.7	98.4
52-week high/low		481.5p	212.5p

Business description

Focusrite is a global music and audio products group that develops and markets hardware and software products, used by both audio professionals and amateurs to realise the high-quality production of recorded and live sound.

Next events

Pre-close	September 2018
Final results	November 2018

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Edison profile page

FocusriteFocusrite is a research client of Edison Investment Research Limited

Interim results: 27% pre-tax growth despite £ strength

H1 results show consistent and substantial organic growth across the business. Revenue grew by 21.2% y-o-y, EBITDA by 30.0% and operating profit by 36.3%. Operating margin improved from 14.3% to 16.0%, driving a 27% growth in pre-tax profit. There were no exceptional items in either year. Net cash has grown since year end by £5.6m to £19.7m.

Exhibit 1: Summary of results

£000s	H117	H217	FY17	H118	H1 y-o-y
Revenue by product type					
Focusrite	20,856	23,696	44,552	25,693	23.2%
Novation	9,604	9,258	18,862	11,419	18.9%
Distribution	1,560	1,081	2,641	1,707	9.4%
Total	32,020	34,035	66,055	38,819	21.2%
Revenue by geography					
USA	13,246	14,744	27,990	16,123	21.7%
Europe and Middle East	12,958	12,195	25,153	15,997	23.5%
Rest of World	5,816	6,317	12,912	6,699	15.2%
Revenue	32,020	34,035	66,055	38,819	21.2%
Gross profit	12,855	13,496	26,351	16,200	26.0%
Gross margin	40.1%	39.7%	39.9%	41.7%	3.9%
Adjusted EBITDA	6,131	6,978	13,109	7,969	30.0%
Adjusted EBITDA margin	19.1%	20.5%	19.8%	20.5%	7.2%
Operating profit	4,571	4,899	9,470	6,230	36.3%
Pre-tax profit	4,599	4,913	9,512	5,833	26.8%
EPS (p)	7.0	7.8	14.8	16.3	133.2%
Net cash	9,391	14,174	14,174	19,734	110.1%

Source: Focusrite, Edison Investment Research

Revenue: Currency movements mask underlying growth profile

Like many much larger companies Focusrite has a largely international market, with c 85% of revenues sourced outside the UK. The medium-term advantage of access to more buoyant consumer economies is arguably counterbalanced by short-term exchange rate risk, but in this period at least, relative sterling strength only serves to highlight that constant currency sales grew even faster than reported revenue, at 26% against the reported 21%.

Exhibit 2: Revenue by region and product area

Year to Aug (£m)	H117	H217	FY17	H118	H1 growth	H1 growth (CC)
Revenue by geography						
US	13,246	14,744	27,990	16,123	21.7%	34%
EMEA	12,958	12,195	25,153	15,997	23.5%	19%
ROW	5,816	6,317	12,912	6,699	15.2%	26%
Revenue by segment						
Focusrite	20,856	23,696	44,552	25,693	23.2%	
Novation	9,604	9,258	18,862	11,419	18.9%	
Distribution	1,560	1,081	2,641	1,707	9.4%	
Revenue	**32,020**	**34,035**	**66,055**	**38,819**	**21.2%**	**26%**

Source: Focusrite

Revenue by region: Constant currency growth twice as fast as in FY17

Constant currency against reported revenue growth now shows an inverse trend compared with FY17. Then, constant currency sales grew by 13% (US: 18%, EMEA: 7% ROW 13%) which, translated to sterling, became 21.6%. In H118, similar sterling growth of 21.1% masks constant currency growth accelerating twice as fast as in FY17, at 26% as shown above.

Regionally, it is impressive that constant currency growth is well into double figures across the board, with the lowest being 19% in Europe, Africa and the Middle East. Here, management reports that all the major territories (UK, Germany and mainland Europe) were in solid growth.

The company noted an especially strong Christmas holiday season for the more consumer-priced products. It is possible that this strength may have altered the seasonal shape of sales.

Trading by product area: Strong and consistent

By division, there has also been consistent growth across the business, with Focusrite division growing revenue at 23% and Novation by 19%. This represents a narrowing of the growth profiles, where for FY17 the growth was 19% and 38% respectively.

Focusrite is seeing continued sales growth in the second generation of its keynote Scarlett range, but also reports 28% growth for the more sophisticated Clarett brand (for product group descriptions see our Outlook note published in November 2017). The Focusrite Professional division formed this year, which targets the very different requirements of major corporate customers of the Red and RedNet brands, is starting to succeed in winning sales, including a major contract in China, albeit its activities only account for c 6% of revenue at the moment.

Novation's signature Launchpad model grew revenue by 26% y-o-y. The company has seen these instruments coming into wider demand from a broader and younger consumer group, who are not necessarily hardcore music hobbyists. For example, their accessibility on Amazon seems to have corresponded with a move by parents buying the product for their teenage children ahead of Christmas. Similarly, the company's own website and others such as Gear4music create a sales platform that faces customers who would not necessarily know a physical music equipment dealer. Novation has also seen synthesizer sales up 90% y-o-y as its newly launched PEAK 8-voice model has gained rapid acceptance following launch in April 2017.

The **AMPIFY** brand's music apps have reached 8.5m downloads compared with 7.5m in FY17, and they are growing at c 0.2m per month. Management believes that app sales are a supportive driver of hardware sales in both the Focusrite and Novation brands.

Balance sheet progress: working capital benefit hitting a peak

Net cash has increased by £5.6m since year end to £19.7m. This net cash inflow is the product of H1 EBITDA of £8.0m and working capital inflows of £1.0m, less capex of £2.0m, dividend payments of £1.0m, and smaller items. The inflow from working capital is likely to reverse to some extent in the full year. A stock increase of 7% to £10.9m is well below the 21% increase in revenue as a result of close management, but if continued could jeopardise stock availability. An increase in creditors of £2m was phased near the end of the period and will probably equalise in the second half.

Forecast: Upgrade with potential upside

We upgrade our PBT forecasts by 4.5% in FY18e and 3.5% in FY19e.

Exhibit 3: Forecast changes

£m	FY18e			FY19e			FY20e		
	Old	New	Change	Old	New	Change	Old	New	Change
Revenues	74.6	75.4	1.2%	79.9	80.0	0.2%	85.9	86.0	0.2%
Gross profit	31.0	31.5	1.4%	33.3	33.4	0.4%	35.9	35.9	0.2%
Gross margin	41.6%	41.7%	0.1%	41.6%	41.7%	0.1%	41.7%	41.7%	0.0%
Adjusted EBITDA	14.6	15.1	3.9%	15.4	15.7	2.0%	16.2	16.7	2.6%
Adjusted EBITDA margin	19.5%	20.1%	0.5%	19.2%	19.6%	0.3%	18.9%	19.4%	0.5%
Normalised operating profit	10.7	11.2	5.2%	11.1	11.5	3.6%	11.6	12.2	5.3%
Normalised PBT	10.4	10.8	4.5%	11.1	11.5	3.5%	11.6	12.2	5.2%
Normalised EPS (p)	15.9	16.3	2.6%	16.8	17.0	1.2%	17.2	17.6	2.2%
Net cash	20.4	20.8	2.0%	23.5	25.5	8.6%	27.4	30.1	9.8%

Source: Edison Investment Research

Essentially, we carry forward the H1 revenue beat of £0.8m at H1 (£30.8m compared with £30.0m expected at pre-close), resulting in a £0.4m improvement at PBT level. We cautiously leave our expectation for H2 unchanged since it is still possible that the trading strength experienced in H1 was a change in the seasonal shape of sales, and that the strong level of demand may not be sustained to the same extent in H2. If it is, there should be further upside to our FY18 forecast.

For FY19e we see a slightly stronger outlook for the € against sterling, resulting in marginally higher revenue and margin, despite any continuing weakness of the US$ in view of the company's natural hedge. Combined with a slight reduction in our operating cost forecast, this results in a £0.4m or 3.5% upgrade in our PBT forecast.

The company has stated its intention to reduce dividend cover over time to between four and five times (FY17: 5.5 times). Our dividend forecast of 3.00p rising to 3.65p by FY20 is equivalent to cover of 5.4 times falling to 4.8 times over the same period.

Cash forecast upgrade

We increase our year-end net cash forecast from £20.4m to £20.8m, which reflects our profit upgrade. It also assumes that working capital will absorb £0.5m in the full year, much less than the 20% of revenue increase that management would consider normal, which would be approximately £2m.

Valuation: Market assumes cash reinvestment

Focusrite is market leader in its specialist field. Its rating is dependent on the market's confidence in its ability to remain at the forefront of a competitive field of technical developments and to service a demanding user group. We believe the company is well placed to sustain this reputation over the medium term, and for this reason we use 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 excess cash of c £20m.

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% (risk-free rate 3%, risk premium 6%, beta 0.9).

The key assumption is the medium-term sustainable revenue growth rate. Here, the current share price is equivalent to a medium-term growth rate of about 12%. In the past three years revenue has grown at 17%, 13% and 22% respectively, which makes such an assumption eminently reasonable; however, whether that level of growth can be sustained for up to seven years ahead is the key question. Exhibit 4 below shows the share price implication of alternative sales growth rates, as well as terminal margin assumptions.

Exhibit 4: Sensitivity to medium-term growth rate and terminal margin

		Sales growth FY21-27				
		8%	10%	12%	14%	16%
Terminal margin	23.0%	502	502	502	502	502
	22.0%	478	478	478	478	478
	21.0%	454	454	454	454	454
	20.0%	430	430	430	430	430
	19.0%	406	406	406	406	406

Source: Edison

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 5: Peer valuations

	P/E (x)		EV/EBITDA (x)		EV/Sales (x)	
	Aug-18	Aug-19	Aug-18	Aug-19	Aug-18	Aug-19
Universal Electronics	18.1	12.9	10.3	7.7	0.8	
Tivo		8.2	10.6	8.9	3.0	2.9
Morgan Advanced Materials	11.7	13.2	7.1	7.5	1.6	1.5
Photo-Me International	16.2	15.1	7.6	7.1	3.5	3.3
Oxford Instruments	17.0	15.8	10.8	10.4	2.9	2.9
Bang & Olufsen	65.6	24.3	13.4	10.0	0.4	0.4
XP Power	21.6	20.0	15.6	14.4	5.1	4.9
Avid Technology		24.7	10.0	7.9	0.4	
Gooch & Housego	25.7	23.6	14.5	13.7	3.8	3.7
Dialight	25.0	14.2	11.5	7.6	1.2	1.2
Quixant	25.8	23.2	18.7	16.7	3.0	2.7
Judges Scientific	21.0	17.6	12.9	12.5	2.7	2.6
B&C Speakers		17.7		12.7	3.0	2.8
Trakm8 Holdings	10.8		6.4		1.4	
Gear4music Holdings	72.9	49.5	35.0	26.1	2.6	2.0
Average	27.6	20.0	13.2	11.7	2.4	2.6
Focusrite	27.3	26.2	16.1	15.6	3.2	3.1
Premium/(discount)	(1.2%)	31.1%	22.6%	33.7%	37.2%	18.7%

Source: Bloomberg, based on market prices at 19 April 2018. Note: All companies calendarised to August.

Focusrite trades on a 1% P/E discount for FY18e but a 31% premium for FY19e. On an EV/EBITDA basis the company trades at a premium of 23% for FY18e and 34% for FY19e. On an EV/Sales basis the company also trades at a premium to the peer group.

The missing valuation piece: Excess cash

While our metrics on the face of it do not point to valuation at or above current market levels, what is left out of the equation is how Focusrite's excess cash of £19.7m may be utilised.

Focusrite generated high average ROCE rates of 44.7% in FY17 and we forecast 51.0% in FY18. On an untaxed basis those rates would be 49.7% and 58.0% respectively.

Exhibit 2: Return on capital employed

£m	2016	2017	2018e
Return			
EBITA	7,140	9,470	11,224
Tax Charge	(811)	(955)	(1347)
Tax Rate	11.4%	10.1%	12.0%
Total Return	6,329	8,515	9,877
Capital employed (year-end)			
Shareholders' equity	25,020	32,884	40,797
Net cash	5,606	14,174	20,783
Total Capital Employed	19,414	18,710	20,014
Average Capital Employed		19,062	19,362
Pre-tax return on capital employed		**49.7%**	**58.0%**
Post tax return on capital employed		**44.7%**	**51.0%**

Source: Edison Investment Research

It is not likely that the company could generate returns from an acquisition equivalent to those of the business it has grown itself. However, using a range of lower ROCE rates, the excess cash would imply additional value as follows:

Exhibit 3: Potential value impact of excess cash (£m/ p per share)

ROCE	10%	15%	20%
Excess cash	19.7	19.7	19.7
Post-tax earnings	2.0	3.0	3.9
Incremental EPS	3.4	5.0	6.7
Pro forma FY19 EPS	20.3	22.0	23.7
Peer P/E	20.0	20.0	20.0
Implied share valuation (p)	406	440	474

Source: Edison Investment Research

Similarly, the effect on our DCF of adding £3.3m (the pre-tax equivalent of the £3.0m in the 15% column above) to our EBITDA, and removing net cash, would be to value the shares at 452p, assuming only annual revenue growth of 8% between FY21 and FY25.

Rather than an assumption of higher organic growth over time, we suggest it is likely that the market is discounting a valuation that assumes utilisation of the cash balance along these lines.

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Exhibit 8: 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					
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	43,719	50,746	57,870
Stocks	11,361	9,000	10,952	11,622	12,494
Debtors	11,224	12,952	11,983	13,593	15,319
Cash & cash equivalents	5,606	14,174	20,783	25,531	30,058
Other	0	0	0	0	0
Current Liabilities	(9,256)	(8,663)	(9,575)	(9,939)	(10,443)
Creditors	(8,612)	(8,204)	(9,318)	(9,632)	(10,080)
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	(536)	(1,965)	(2,150)
Exceptional & other	(417)	137	(0)	(0)	(0)
Tax	(165)	(633)	(1,300)	(1,555)	(1,835)
Net operating cash flow	3,658	13,020	13,292	12,143	12,674
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	6,609	4,748	4,526
Opening net debt/(cash)	(6,173)	(5,606)	(14,174)	(20,783)	(25,531)
FX	0	0	0	0	0
Other non-cash movements	0	0	0	0	0
Closing net debt/(cash)	(5,606)	(14,174)	(20,783)	(25,531)	(30,058)

Source: Company accounts, Edison Investment Research

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