

# Focusrite

## Rising scale

Focusrite's trading statement indicates constant currency sales growth of over 25%, even better sales growth than the headline 19%, because of the US dollar's depreciation. The background is a continuation of widespread demand for the full product range across all the main geographies. Although trading patterns may be shifting to the first half, we are upgrading our forecasts by c 5%.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	EV/EBITDA (x)	Yield (%)
8/16	54.3	7.7	11.8	2.0	30.1	19.6	0.5
8/17	66.1	9.5	14.8	2.7	24.0	14.6	0.8
8/18e	74.6	10.4	15.9	3.0	22.3	13.2	0.8
8/19e	79.9	11.1	16.8	3.3	21.2	12.5	0.9

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

## Strong Christmas drives positive half year trading

Focusrite has released a very encouraging pre-close half-year trading statement. Revenue, cash and profits have all grown y-o-y, the latter implying costs are not expected to be out of line. Trends seen in FY17 have continued, with growth spread across product groups and in all major geographies. Strong sales had a "particularly strong boost" through increased demand over the Christmas holiday period, which may signal a wider consumer appreciation of the products, with a sign of a change in the phasing of revenue. End February 2018 net cash was £19.7m, up from £14.2m at end August 2017.

## Underlying sales exceed headline growth

Guidance of H118 revenue of at least £38m implies growth of 19% y-o-y. This is spread across all regions and sales in US\$ regions, amounting to around 60% of revenue, led growth in FY17. Given that the US\$ has depreciated by c 8% y-o-y, underlying sales growth has been even stronger, at over 25%.

## Underlying upgrade of 5%

We upgrade our FY18e EBITDA by 5.3% and PBT by 3.7%. The latter is lower because we believe the relative strength of sterling in H1 will bring some currency losses on the translation of US\$ cash. For FY19e, we upgrade PBT by 5% and EBITDA by 3.9%. We now forecast year-end net cash of £20.4m (previously £17.6m) carrying forward the H1 advance.

## Valuation: 379-400p

Our DCF valuation is 379p/share, which would put the shares on an FY18e P/E of 23.8x and EV/EBITDA of 14.1x. A comparison against peers, taking into account £20m of excess cash, suggests a somewhat higher level of 400p.

## Interim pre-close statement

### Consumer Electronics

9 March 2018

**Price** 355p  
**Market cap** £206m

Net cash (£m) at 28 February 2018	19.7
Shares in issue	58.1m
Free float	58%
Code	TUNE
Primary exchange	AIM
Secondary exchange	N/A

### Share price performance



%	1m	3m	12m
Abs	7.6	11.8	76.2
Rel (local)	6.5	14.2	76.7
52-week high/low	367.5p	201.5p	

### 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

Interim results	24 April 2018
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### Analysts

Paul Hickman	+44 (0)20 3681 2501
Neil Shah	+44 (0)20 3077 5715

[consumer@edisongroup.com](mailto:consumer@edisongroup.com)

[Edison profile page](#)

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## Positive half year trading: Strong Christmas

Focusrite has released a very encouraging pre-close half-year trading statement which, though brief, bears some analysis.

Revenue, profits and cash have all grown compared with the first half of the last financial year. The extent to which profit as well as revenue and cash have grown will not be confirmed until results are released. However, we take this to mean that costs are not expected to be out of line.

We understand that trends seen in FY17 have broadly continued. Those were, firstly, growth in all geographies, but led by the US and Rest of World (mainly Asia), and secondly growth in both divisions, led by Novation. Focusrite continues to build its leading international positions in its specialised markets of audio interfaces and sound generation.

It is reassuring that growth has also been widely spread across product groups and that both the Scarlett and Launchpad ranges have grown strongly. Accelerating growth in the Novation group was one of the positive features of FY17, so that it increased its share of total revenue from 25% in FY16 to 29% in FY17.

Strong sales had a "particularly strong boost" with increased demand over the Christmas holiday period, and management raises the idea that this may signal a wider consumer appreciation of the products, with a sign of a change in the phasing of revenue. The trend has been towards high profile products, such as the Novation's Launchpad, being selected as Christmas presents. This may have been helped by their availability more widely, for example on Amazon, rather than the previous concentration in specialist music dealerships.

## Forecasts: Underlying upgrade of 5%

We upgrade our forecasts in line with guidance of H118 revenue of over £38m, up 19% y-o-y, as well as end February 2018 net cash of £19.7m, up from £14.2m at end August 2017. We estimate that the strengthening of the US\$ against sterling from an average rate of 1.26 in H117 to c 1.38 in H118 will have meant an 8% depreciation in the sterling value of US\$ sales making up c 60% of total revenue, so that underlying constant currency growth, at over 25%, was even stronger than the headline 19%. However, the natural hedge that the company enjoys against the US\$ means that there should be no material effect on margin.

**Exhibit 1: Changes to forecasts**

£m	FY18e old	FY18e new	% change	FY19e old	FY19e new	% change	FY20 old	FY20e new	% change
Revenues	72.7	74.6	2.5%	78.6	79.9	1.7%	84.9	85.9	1.2%
Gross profit	30.3	31.0	2.6%	32.7	33.3	1.8%	35.3	35.9	1.6%
Gross margin	41.6%	41.6%	0.0%	41.6%	41.6%	0.0%	41.6%	41.7%	0.1%
Adjusted EBITDA	13.8	14.6	5.3%	14.8	15.4	3.8%	15.6	16.2	3.9%
Adjusted EBITDA margin	19.0%	19.5%	0.5%	18.8%	19.2%	0.4%	18.4%	18.9%	0.5%
Normalised operating profit	10.0	10.7	7.1%	10.5	11.1	5.3%	11.0	11.6	4.9%
Normalised PBT	10.0	10.4	3.7%	10.6	11.1	5.3%	11.1	11.6	4.8%
Normalised EPS (p)	15.3	15.9	3.7%	15.9	16.8	5.3%	16.4	17.2	4.8%
Net cash	17.6	20.4	15.5%	20.6	23.5	14.2%	24.3	27.4	12.6%

Source: Edison Investment Research

We are cautious in our forecast for the second half, as a result of the possibility that trading patterns may have changed, giving a seasonal boost to Christmas. Our H2 revenue forecast now only represents 7.5% y-o-y growth which on the face of it looks cautious. On the other hand, it represents a 51:49 split of sales between H1 and H2, against a 48.5:51.5 split in FY17.

## Cash forecast – at least £20m

The £5.5m increase in net cash compared with August 2017 implies a further improvement in our previous FY18 full year net cash flow forecast of £3.4m. We now forecast £20.4m net cash at end August 2018. In part, this represents the £0.6m improvement in our forecast EBITDA. More importantly, it reflects efficient utilisation of working capital, particularly inventory, which we now expect to turn 4.9x, close to FY17's level of 4.8x, which we had treated as temporarily low. Given that year end has in the past seen a higher cash balance than H1, we would not be surprised to see this level exceeded.

## Valuation: 379-400p

Focusrite is market leader in its specialist technical 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. The company is showing an ability to sustain this reputation and for this reason we use a DCF projection to place a value on the longer-term income stream available to investors.

## DCF valuation of 379p

We make no change to our DCF projection which extends our forecasts out to 10 years on growth fading in the last three years to a terminal rate of 2%. We assume a terminal EBITDA margin of 21% (2017 actual: 19.8%) and capex investment (including R&D) 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), resulting in a valuation of 379p/share (of which 234p is in the terminal value). That would put the shares on an FY18 P/E of 23.8x and EV/EBITDA of 14.1x.

## Peer group comparison: 400p

As there is no close small-cap peer, we define the relevant group as 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.

<b>Exhibit 2: Peer valuation</b>								
All calendarised to August	Country	Mid-price (ccy)	Mkt cap (ccy) m	Mkt cap £m	P/E (x) Yr 1e	P/E (x) Yr 2e	EV/EBITDA (x) Yr 1e	EV/EBITDA (x) Yr 2e
Universal Electronics	US	52.7	742	570	15.4	12.8	8.9	7.6
Tivo	US	15.0	1836	2160	9.1	7.5	9.5	8.5
Morgan Adv. Materials	UK	326.6	933	920	13.4	12.6	5.6	5.3
Photo-Me International	UK	178.4	672	672	18.2	17.0	6.1	5.7
Oxford Instruments	UK	765.0	439	561	14.4	13.4	7.9	7.6
Bang & Olufsen	DK	168.2	7275	871	134.7	29.6	101.5	75.6
XP Power	UK	3390.0	644	655	20.0	18.9	10.5	10.0
Avid Technology	US	5.1	210	162	15.3	6.8	7.7	N/A
Gooch & Housego	UK	1382.5	340	337	24.7	23.4	10.0	9.5
Dialight	UK	537.0	176	212	17.8	12.7	6.5	5.0
Quixant	UK	387.5	256	276	24.1	21.1	12.4	10.6
Judges Scientific	UK	2160.0	133	119	17.0	16.2	8.4	7.5
B&C Speakers	IT	11.8	129	112	18.1	17.3	10.3	9.4
Trakm8 Holdings	UK	96.0	34	54	13.3	9.6	5.6	4.6
Gear 4 Music (Hldgs)	UK	639.0	133	153	81.9	52.8	25.7	18.7
Average					29.2	18.1	15.8	13.3
Focusrite	UK	360		209	22.6	21.5	13.4	12.7
Premium/(discount)					-22.4%	18.6%	-15.1%	-4.3%

Source: Bloomberg. Note: LSE subsectors: Electrical Components & Equipment, Computer Hardware, Recreational Products; Retail: relevant audio/video companies from US and European markets. Market cap £25m-2bn. Outliers excluded from table. Prices as at 8 March 2018. N/A: data not available.



Focusrite trades at an average FY18e 22.4% discount and FY19e 18.6% P/E premium to the group. On an EV/EBITDA basis it trades at an FY18e 15.1% and an FY19e 4.3% discount to the group. However, we note the now significant excess cash of £19.7m, for which the P/E measure gives no credit (the EV/EBITDA valuation does). Adjusting to average peer multiples and allowing for that cash in the P/E comparison values Focusrite shares at 418p on a P/E basis and 382p on an EV/EBITDA basis, a blend of 400p, somewhat above our DCF valuation.

**Exhibit 3: Financial summary**

	£'000s	2016	2017	2018e	2019e	2020e
31-August		IFRS	IFRS	IFRS	IFRS	IFRS
<b>INCOME STATEMENT</b>						
Revenue		54,301	66,055	74,552	79,890	85,882
Cost of Sales		(33,439)	(39,704)	(43,503)	(46,618)	(50,028)
Gross Profit		20,862	26,351	31,049	33,272	35,853
EBITDA		10,249	13,109	14,563	15,360	16,239
Operating profit (before amort. and except).		7,677	9,470	10,674	11,072	11,573
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	10,674	11,072	11,573
Net Interest		(14)	42	(300)	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	10,374	11,122	11,623
Profit Before Tax (reported)		7,126	9,512	10,374	11,122	11,623
Reported tax		(870)	(959)	(1,245)	(1,501)	(1,743)
Profit After Tax (norm)		6,793	8,553	9,129	9,620	9,880
Profit After Tax (reported)		6,256	8,553	9,129	9,620	9,880
Minority interests		0	0	0	0	0
Discontinued operations		0	0	0	0	0
Net income (normalised)		6,900	8,553	9,129	9,620	9,880
Net income (reported)		6,256	8,553	9,129	9,620	9,880
Basic average number of shares outstanding (m)		53.2	55.4	56.0	56.0	56.0
EPS - basic normalised (p)		13.0	15.4	16.3	17.2	17.6
EPS - normalised (p)		11.8	14.8	15.9	16.8	17.2
EPS - basic reported (p)		11.8	15.4	16.3	17.2	17.6
Dividend per share (p)		2.0	2.7	3.0	3.3	3.7
Revenue growth (%)		13.1	21.6	12.9	7.2	7.5
Gross Margin (%)		38.4	39.9	41.6	41.6	41.7
EBITDA Margin (%)		18.9	19.8	19.5	19.2	18.9
Normalised Operating Margin		14.1	14.3	14.3	13.9	13.5
<b>BALANCE SHEET</b>			<b>13,748</b>	<b>13,717</b>	<b>16,687</b>	<b>18,820</b>
Fixed Assets		6,367	6,332	6,897	8,395	9,948
Intangible Assets		4,792	4,963	5,701	7,371	9,073
Tangible Assets		1,575	1,369	1,196	1,024	875
Investments & other		0	0	0	0	0
Current Assets		28,191	36,126	43,313	50,341	56,802
Stocks		11,361	9,000	8,939	10,728	11,650
Debtors		11,224	12,952	14,005	16,102	17,781
Cash & cash equivalents		5,606	14,174	20,369	23,510	27,371
Other		0	0	0	0	0
Current Liabilities		(9,256)	(8,663)	(9,686)	(10,697)	(11,254)
Creditors		(8,612)	(8,204)	(9,227)	(10,143)	(10,611)
Tax and social security		(644)	(459)	(459)	(554)	(643)
Short term borrowings		0	0	0	0	0
Other		0	0	0	0	0
Long Term Liabilities		(282)	(245)	(285)	(375)	(467)
Long term borrowings		0	0	0	0	0
Other long term liabilities		(282)	(245)	(285)	(375)	(467)
Net Assets		25,020	33,550	40,239	47,664	55,029
Minority interests		0	0	0	0	0
Shareholders' equity		25,020	33,550	40,239	47,664	55,029
<b>CASH FLOW</b>						
Op Cash Flow before WC and tax		10,249	13,109	14,563	15,360	16,239
Working capital		(6,009)	407	(635)	(2,971)	(2,132)
Exceptional & other		(417)	137	(0)	(0)	(0)
Tax		(165)	(633)	(1,245)	(1,501)	(1,743)
Net operating cash flow		3,658	13,020	12,683	10,888	12,364
Capex		(3,675)	(3,614)	(4,535)	(5,914)	(6,435)
Acquisitions/disposals		0	0	0	0	0
Net interest		(111)	(42)	(300)	50	50
Equity financing		172	258	0	0	0
Dividends		(976)	(1,138)	(1,653)	(1,882)	(2,118)
Other		365	84	0	0	0
Net Cash Flow		(567)	8,568	6,195	3,141	3,860
Opening net debt/(cash)		(6,173)	(5,606)	(14,174)	(20,369)	(23,510)
FX		0	0	0	0	0
Other non-cash movements		0	0	0	0	0
Closing net debt/(cash)		(5,606)	(14,174)	(20,369)	(23,510)	(27,371)

Source: Company accounts, Edison Investment Research

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