

Focusrite

Interim results

Strong delivery with further potential

A number of factors have combined to produce excellent interim results for Focusrite: strong demand for its leading products, exposure to the buoyant US market, a promising result from sales to Amazon, good margin control, and a significant increase in cash generation. We are upgrading our forecasts, cautiously in view of consumer markets, although opportunities in the Far East and online represent potential upside.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	EV:EBITDA (x)	Yield (%)
08/15	48.0	7.2	10.5	1.8	21.2	13.4	0.8
08/16	54.3	7.7	11.8	2.0	18.9	12.2	0.9
08/17e	64.9	8.5	12.8	2.3	17.4	10.3	1.0
08/18e	70.5	9.2	13.9	2.4	16.0	9.2	1.1

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

Happy conjunction of positive factors

These results mark a conjunction of several positive factors. Both arms of the business are succeeding, with the Focusrite product group still benefiting from the June 2016 of the Scarlett second-generation launch plus new products, while Novation's Launchpad is reflecting a wave of popular appeal. Currency is providing net benefits and cash has been boosted with good working capital control.

Strong interim results

Interim results were strong. Revenue was up by 23.7%, with constant currency growth of 12% shared between both product groups. Adjusted pre-tax profit grew by 55% and adjusted EPS by 52%. All regions are in revenue growth, led by the US, which grew 25% on a constant currency basis. Gross margin rose 30bp to 40.1% and EBITDA margin by 50bp to 19.1% year-on-year. Cash has been positively managed with net inflow of £3.8m against an outflow of £2.2m a year ago and closing net cash of £9.4m. We upgrade our FY17 earnings forecast by 5%.

Further positive opportunities

The combination of positive elements does not mean that opportunities are absent. Some result from issues that can be fixed and others from new areas yet to be exploited. Fixable issues include those with certain country distributors and additional product developments for the smaller, growing ranges such as Clarett, Red and Circuit. Open opportunities are the positive early inroads made into the enormous Chinese market and the potential for the online popular market suggested by the first year of selling directly to Amazon in EMEA.

Valuation: Modest increase

On upgraded revenue and cash forecasts, we are raising our DCF-based valuation from 214p to 249p, which is close to our peer valuation of 244p. Further development of the Far East opportunity and extension of the Launchpad demand boost through Amazon are factors that could be a catalyst for the share price.

Consumer electronics

3 May 2017
Price 222.50p
Market cap £129m

Net cash (£m) at February 2017 9.4

Shares in issue 58.1m

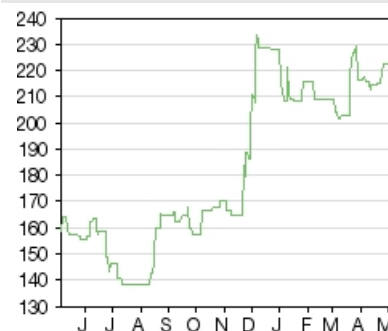
Free float 39%

Code TUNE

Primary exchange AIM

Secondary exchange N/A

Share price performance



%	1m	3m	12m
Abs	2.8	3.0	41.3
Rel (local)	2.3	0.2	21.1
52-week high/low	233.5p		138.0p

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

Pre-close September 2017

Final results November 2017

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Interim results: Excellent on sales, profit and cash

Summary of results: Significant growth in revenue, profit and cash

Focusrite has reported strong interim results, on a number of dimensions:

- Results are up decisively with adjusted PBT growth of 55% and EPS growth (diluted and adjusted) of 52%.
- Revenue is up by 23.7% and this is backed by constant currency growth of 12%.
- All regions are in revenue growth, led by the US, which grew 25% on a constant currency basis.
- Gross margin is up from 39.8% to 40.1%.
- Both product groups are performing well, with the Focusrite group benefiting from the June 2016 new-generation Scarlett launch, and Novation from its signature Launchpad model.
- EBITDA margin rose from 18.6% to 19.1% and operating margin remained at 14.3% year-on-year.
- Cash has been positively managed with net inflow of £3.8m against an outflow of £2.2m a year ago, to leave £9.4m net cash at February 2017.

Exhibit 1: Summary of interim results					
£'000s	H116	H216	2016	H117	Y-o-y H1
Revenue by product type					
Focusrite	16,946	20,617	37,563	20,856	23.1%
Novation	7,287	6,396	13,683	9,604	31.8%
Distribution	1,647	1,408	3,055	1,560	-5.3%
Total	25,880	28,421	54,301	32,020	23.7%
Revenue by geography					
US	9,069	12,313	21,382	13,246	46.1%
Europe and Middle East	12,064	10,518	22,582	12,958	7.4%
Rest of World	4,747	5,590	10,337	5,816	22.5%
Total	25,880	28,421	54,301	32,020	23.7%
Gross profit	10,305	10,557	20,862	12,855	24.7%
Gross margin	39.8%	37.1%	38.4%	40.1%	0.8%
Adjusted EBITDA	4,821	5,428	10,249	6,131	27.2%
Adjusted EBITDA margin	18.6%	19.1%	18.9%	19.1%	2.8%
Operating profit	3,692	3,985	7,677	4,571	23.8%
Pre-tax profit	2,969	4,694	7,663	4,599	54.9%
EPS (p)	4.6	6.9	11.4	7.0	52.2%
Cash	3,952	5,606	5,606	9,391	137.6%

Source: Focusrite

Performance by product group

Novation product group: Outstanding performance

Novation products have benefited in all geographies from a recent marked improvement in interest and adoption of grid controllers, seen particularly among younger customers. Launchpad is Novation's brand in the grid controller format, although the upturn has also been noted by competitors.

The rise in demand reflects the greater adoption of these products by high-profile DJs and musicians, who feature the products on their YouTube performances (Launchpad is also widely used to create tribute versions of dance numbers). This combines with the fact that Launchpad is now readily available on Amazon, which is a much wider market than in the past. The upturn in

demand is brought into higher relief by comparison with a quieter year in FY16, without so many new products as the year before.

Linked to the boost in Launchpad sales, management also notes an increase in its Midi keyboard, Launchkey, which helps musicians to digitise their performance in an intuitive way. Meanwhile, although the Circuit grid-based groove box continues to grow revenue, management is considering a repositioning to improve performance. Circuit was first launched in October 2015 and is now being updated partly in response to the suggestions made in the active online forums.

App penetration increases

The number of downloads of the Launchpad and BlocsWave apps have now surpassed 6m, growing at around 100,000 per month. The investment in this team and the associated income are both increasing.

Focusrite product group: Scarlett effect plus new products

Focusrite's revenue growth, at 23.1%, is comparable to that of the company as a whole, of which it makes up two-thirds. It continues to build market share following the renewal of the Scarlett range in June 2016. The second-generation Scarlett range is continuing to gain market share, which is significant as it is already market leader in most of its key markets. The continuation of share gains, from 40% to 49% over the last year, gives assurance that the benefits of the second-generation launch are not just short term, although clearly in FY18 it will be lapping post-launch sales.

Six new products have been launched in the first half: Red 8Pre, Clarett OctoPre, Scarlett OctoPre, Scarlett OctoPre Dynamic, iTrack One Pre and Launch Control XL MK2, as well as a Circuit Components Update. Spanning different price segments and target customer groups, these are aimed at increasing penetration and reach. Feedback from customers, retailers and distributors has been positive to date.

Performance by market

US market: Strong underlying growth

Foreign exchange nearly doubled revenue growth to a remarkable 46%, but even before the dollar effect, constant currency growth of 25% is impressive. It emphasises the fact that the company's largest market (41% of total revenue) is also its fastest growing, and this is in a consumer economy that is better placed than the UK and most of Europe. Renewed growth from Novation, against a weaker comparative, was one factor fuelling growth, and accelerating demand for commercial and professional-level products in the RedNet range was another. This technology enables simultaneous distribution of multiple signals at high quality, and is significant because it represents increased penetration of a major new market, the live sound and broadcast business-to-business market, which offers further growth opportunities ahead. In addition, the second-generation Scarlett USB range continued to generate good demand, as elsewhere.

EMEA market: Overall growth

Here headline growth of 7% was equivalent to 5% on a constant currency basis, and the picture was more mixed. Growth in the UK was strong at 16%. Clearly, there were declines elsewhere, although this is probably the result in channel changes, and specifically the move online. The adoption of Amazon directly by the company as a sales channel (it was previously used by distributors) is significant and within the last year has risen to represent 13% of EMEA revenue, or around £1.7m in the half. All the incremental sales via Amazon are classified as UK sales, although in practice part of them will have been ordered by customers abroad. So the development of the Amazon channel may be diverting other European sales to the UK category.

Rest of World market: Contrasting picture, encouraging outlook

As with the US, underlying constant currency growth was below the headline at 8% against 22%, but was still significant. The result was the net of some contrasts. Growth in revenue in China reflects early achievement for the new sales office in Hong Kong, and is very promising in view of the size of the market there. Indications are that the fast expanding middle class is developing a strong taste for western popular music, and Focusrite's principle of making music easy to make is closely aligned with this need. However, declines in Japan and South Korea resulted from issues with the distributor there, which the company is working to resolve. Asia has already been highlighted as a strategic focus area and management intends to continue building its presence with expansion of the sales team, albeit from a low base. Latin America remains a potential growth area, and although it has not received specific growth focus to date, there is a suggestion that it may do so in future, although this is more likely to be through an online presence than a physical establishment.

E-commerce: Promising indications

The e-commerce initiative, launched softly in March 2016, has grown its penetration to over 1% of revenue and clearly has much further to go. In its initial phase it was focused on refurbished products, but management has now started to expand its application to a wider range of products and this is leading to a growth in demand in both the e-commerce channel and the existing dealer network. The strength of Amazon sales is a good indicator of a level of demand through e-commerce channels, and we think it is likely that the company will continue to grow its own e-commerce store, while at the same time recognising the continuing importance of distributor and dealer channels with the important service element that they provide.

Forecast: Cautiously upgrading

We are upgrading our pre-tax profit and earnings forecasts for FY17 by 5.4%.

We assume lower underlying revenue growth of 8% in the second half year compared with 12% in the first, as a result of our overall caution on consumer demand, notwithstanding the independent growth demonstrated in H1 and the company's 40%+ revenue exposure to the strong US market. It is also inevitable that the boost from the launch of the second-generation Scarlett range in June 2016 will start to fade, and will begin to lap itself by the end of the year. On the other hand, the current demand for Novation's Launchpad, particularly through the Amazon channel, is encouraging. We expect gross margin of 40.9% in H1 to flatten to 38.0% in the full year as the euro currency advantage from H1 reduces. Conversely, we expect the 25% growth in operating costs in H1, which was driven by timing, to flatten in the full year to 23%.

Similarly we are cautious on revenue growth for FY18 and assuming revenue growth of 9%. We upgrade pre-tax profit and earnings per share by 4%.

Exhibit 2: Forecast changes									
	Revenue (£m)			PBT (£m)			EPS (p)		
	Old	New	Change	Old	New	Change	Old	New	Change
08/16	54.3	54.3	N/A	7.7	7.7	N/A	11.8	11.8	N/A
08/17e	62.6	64.9	3.6%	8.0	8.5	5.4%	12.1	12.8	5.4%
08/18e	68.3	70.5	3.2%	8.8	9.2	4.2%	13.3	13.9	4.2%

Source: Focusrite, Edison Investment Research

We expect working capital to remain well controlled and as a result year-end net cash to increase to £10.8m.

Valuation

We believe Focusrite is well placed to achieve sustained earnings and dividend growth based on its ability to remain at the forefront of its competitive and technical market. We value the shares using a DCF projection to place a value on the longer-term income stream available to investors. Although there are few close peers, we also consider valuation relative to a group of smaller companies on near-term earnings expectations.

DCF valuation of 249p

To create a DCF projection we extend our forecast using similar revenue growth and margin assumptions for two years, and out to 10 years on growth, fading in the last three years to a terminal rate of 2%. We assume terminal EBITDA margin of 19.3% (2019e: 17.5%) and capex investment at 7% of revenue, reducing to 6% in the terminal period. We assume an equity-only cost of capital of 8.4% (risk-free rate 2%, risk premium 7%, beta 0.9), resulting in a valuation of 249p/share (of which 142p is in the terminal value). All assumptions are unchanged except that we have increased our terminal margin assumption by 30bp reflecting our higher forecast. Our previous valuation was 214p. This would put the shares on an FY17e P/E of 19.5x and EV/EBITDA of 11.5x. Varying the cost of capital and the terminal growth assumption would give the following ranges:

Exhibit 3: DCF assumption scenario analysis (p)					
	-----Terminal growth rate-----				
Cost of capital	0.0%	1.0%	2.0%	3.0%	4.0%
10.0%	175	184	196	210	230
9.0%	197	210	226	248	278
8.0%	225	243	267	301	351
7.0%	262	288	325	380	472

Source: Edison Investment Research

Varying our assumed sales growth and margin assumptions affects the valuation as follows:

Exhibit 4: Growth and margin assumption scenario analysis						
		-----Sales growth 2019-20e-----				
		6%	7%	8%	9%	10%
Margin change pa 2020-25e	0.6pp	244	260	277	294	313
	0.5pp	236	251	267	284	302
	0.4pp	228	243	258	275	292
	0.3pp	220	234	249	265	282
	0.2pp	212	225	240	255	271

Source: Edison Investment Research

In addition, our valuation would change by c ±40p for every 1pp change in our discount rate.

Peer group comparison

In our view the small-cap market is the most appropriate context for Focusrite. As there is no close 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.

For calendar 2017, Focusrite trades at an average 13.1% P/E discount and an average 2.6% EV/EBITDA premium to the group, which suggests that the lower P/E rating reflects its favourable cash-rich capital structure and low tax rate resulting from its ongoing investment in R&D. EV/Sales at 1.6x is close to peers. Adjusting to average peer multiples values Focusrite shares at 257p on a P/E basis and 231p on an EV/EBITDA basis, a blend of 244p, which is close to our DCF valuation.

Exhibit 5: Peer valuation

Calendarised	Country	Price	Market cap		EV £m	P/E (x)		EV/Sales (x)		EV/EBITDA (x)	
			CCYm	£m		2017	2018	2017	2018	2017	2018
Universal Electronics	US	70.6	1,017	783	782	19.7	N/A	N/A	N/A	N/A	N/A
Tivo	US	19.4	2,350	1,808	2,220	8.8	9.2	2.9	2.7	6.6	6.1
Morgan Adv. Materials	UK	330.6	943	943	1,262	15.3	13.6	0.9	0.9	6.5	6.1
Photo-Me International	UK	166.6	624	624	536	17.3	16.1	1.9	1.8	6.3	5.9
E2V Technologies	UK	-	603	603	633	N/A	N/A	1.8	1.6	7.9	6.9
Oxford Instruments	UK	894.5	512	512	696	16.5	15.4	1.4	1.3	8.7	8.0
DTS	US	-	760	760	856	N/A	N/A	N/A	N/A	N/A	N/A
XP Power	UK	2637.5	510	510	505	21.8	20.4	2.7	2.6	10.9	10.3
Avid Technology	US	5.6	230	177	291	20.1	N/A	N/A	N/A	N/A	N/A
Gooch & Housego	UK	1260.0	303	303	288	25.6	22.7	2.2	1.9	10.8	9.2
TT Electronics	UK	200.8	326	326	395	15.0	13.6	0.5	0.5	5.5	5.1
Dialight	UK	977.0	319	319	310	27.4	19.2	1.2	1.1	9.5	7.3
Quixant	UK	406.5	266	266	274	27.4	0.0	2.5	N/A	14.8	N/A
Judges Scientific	UK	1537.5	94	94	100	14.6	13.4	1.3	1.2	7.7	6.7
B&C Speakers	IT	12.7	140	116	115	19.7	18.6	3.0	2.9	11.7	11.4
Trakm8 Holdings	UK	77.5	28	28	29	12.4	N/A	N/A	N/A	N/A	N/A
Gear4music (Hldgs)	UK	523.0	105	105	102	47.0	37.4	1.1	0.9	21.3	16.8
Average						20.2	17.7	1.7	1.6	9.9	8.3
Focusrite	UK	223	130	130	17.6	16.6	1.8	1.6	10.1	9.0	9.0
Premium/(discount)						-13.1%	-6.5%	5.0%	-2.2%	2.6%	8.6%

Source: Bloomberg. LSE subsectors Electrical Components & Equipment, Computer Hardware, Recreational Products; relevant audio/video companies from US and European markets. Market cap £25m-1bn. Note: Outliers excluded from table. Prices as at 26 April 2017. N/A = data not available.

Exhibit 6: Financial summary

	£'000s	2015	2016	2017e	2018e	2019e
31-August		IFRS	IFRS	IFRS	IFRS	IFRS
INCOME STATEMENT						
Revenue		48,029	54,301	64,866	70,519	76,160
Cost of Sales		(29,381)	(33,439)	(40,192)	(43,510)	(46,991)
Gross Profit		18,648	20,862	24,674	27,008	29,169
EBITDA		9,302	10,249	11,627	12,628	13,628
Normalised operating profit		7,024	7,677	8,438	9,149	9,702
Amortisation of acquired intangibles		0	0	0	0	0
Exceptionals		(704)	(537)	0	0	0
Share-based payments		0	0	0	0	0
Reported operating profit		6,320	7,140	8,438	9,149	9,702
Net Interest		164	(14)	38	40	45
Joint ventures & associates (post tax)		0	0	0	0	0
Exceptionals		0	0	0	0	0
Profit Before Tax (norm)		7,188	7,663	8,476	9,189	9,747
Profit Before Tax (reported)		6,484	7,126	8,476	9,189	9,747
Reported tax		(1,022)	(870)	(1,017)	(1,103)	(1,455)
Profit After Tax (norm)		6,166	6,793	7,459	8,086	8,292
Profit After Tax (reported)		5,462	6,256	7,459	8,086	8,292
Minority interests		0	0	0	0	0
Discontinued operations		0	0	0	0	0
Net income (normalised)		6,166	6,900	7,459	8,086	8,292
Net income (reported)		5,462	6,256	7,459	8,086	8,292
Basic average number of shares outstanding (m)		52.4	53.2	54.1	55.1	55.1
EPS - basic normalised (p)		11.8	13.0	13.8	14.7	15.1
EPS - normalised (p)		10.5	11.8	12.8	13.9	14.2
EPS - basic reported (p)		10.4	11.8	13.8	14.7	15.1
Dividend (p)		1.80	1.95	2.25	2.40	2.55
Revenue growth (%)		17.2	13.1	19.5	8.7	0.0
Gross Margin (%)		38.8	38.4	38.0	38.3	38.3
EBITDA Margin (%)		19.4	18.9	17.9	17.9	17.9
Normalised Operating Margin		14.6	14.1	13.0	13.0	12.7
BALANCE SHEET						
Fixed Assets		5,264	6,367	7,405	8,631	9,787
Intangible Assets		3,941	4,792	5,510	6,573	7,626
Tangible Assets		1,323	1,575	1,895	2,058	2,161
Investments & other		0	0	0	0	0
Current Assets		22,766	28,191	32,361	38,761	45,295
Stocks		8,633	11,361	10,848	11,744	12,812
Debtors		7,737	11,224	10,678	11,802	12,746
Cash & cash equivalents		6,173	5,606	10,834	15,215	19,736
Other		223	0	0	0	0
Current Liabilities		(8,809)	(9,256)	(8,025)	(8,634)	(9,479)
Creditors		(8,406)	(8,612)	(7,381)	(7,990)	(8,629)
Tax and social security		(403)	(644)	(644)	(644)	(850)
Short term borrowings		0	0	0	0	0
Other		0	0	0	0	0
Long Term Liabilities		(743)	(282)	(328)	(397)	(465)
Long term borrowings		0	0	0	0	0
Other long term liabilities		(743)	(282)	(328)	(397)	(465)
Net Assets		18,478	25,020	31,413	38,362	45,138
Minority interests		0	0	0	0	0
Shareholders' equity		18,478	25,020	31,413	38,362	45,138
CASH FLOW						
Op Cash Flow before WC and tax		9,302	10,249	11,627	12,628	13,628
Working capital		(1,689)	(6,009)	(173)	(1,410)	(1,373)
Exceptional & other		(591)	(417)	(0)	(0)	(0)
Tax		(838)	(165)	(1,017)	(1,103)	(1,455)
Net operating cash flow		6,184	3,658	10,437	10,115	10,800
Capex		(3,559)	(3,675)	(4,030)	(4,453)	(4,894)
Acquisitions/disposals		0	0	0	0	0
Net interest		6	(111)	38	40	45
Equity financing		0	172	0	0	0
Dividends		(314)	(976)	(1,217)	(1,322)	(1,430)
Other		53	365	0	0	0
Net Cash Flow		2,370	(567)	5,228	4,381	4,521
Opening net debt/(cash)		(3,803)	(6,173)	(5,606)	(10,834)	(15,215)
FX		0	0	0	0	0
Other non-cash movements		0	0	0	0	0
Closing net debt/(cash)		(6,173)	(5,606)	(10,834)	(15,215)	(19,736)

Source: Focusrite, Edison Investment Research

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