Focusrite

Tuning up

Full-year pre-close statement

Consumer electronics

Following a strong first half driven in part by known product launches, this equally strong second half appears to show a more fundamental improvement resulting from sustained sales growth and improving mix together with margin and cash management in Focusrite's international markets. These factors underpin our conviction that the company has sustainable independent strength.

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	26.1	16.9	0.6
8/17e	66.0	9.2	13.9	2.3	22.1	13.3	0.7
8/18e	71.8	9.7	14.6	2.4	21.0	12.2	0.8
8/19e	77.5	10.3	15.0	2.6	20.5	11.1	0.8

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

Revenue and profit over-performance: FY17e upgrade

Focusrite has had an excellent second half. Revenue was up c 22% for the year, implying c 20% revenue growth in the second half. The fact that both revenue and profit are now guided ahead of the first half raises our expected pre-tax profit for the full year by £0.7m, or 8.8% to £9.2m.

Combination of positive sales and margin factors

Reasons for the strong H2 include improved product sales, which moreover were weighted towards higher-margin product areas, foreign exchange benefits against the € (though fx is never a major factor for Focusrite given its natural dollar hedge); and active gross margin management. As a result of these factors, our expected FY17 gross margin rises one whole percentage point from 38.0% to 39.0%.

Margin gains should be sustainable into FY18

With a continuing focus on margin management, we believe a 39.2% gross margin should be achievable in FY18, driving a 5.7% PBT and EPS upgrade.

Major improvement in cash performance

Net cash of £14.2m is up from £5.6m at August 2016 and £9.4m at February 2017. Net cash inflow of £8.6m is a much stronger cash performance than our forecast £5.2m. This is largely the result of better working capital management, particularly inventory. We raise our FY18 net cash forecast by £3m to £18.1m.

Valuation: Margin upgrade drives higher valuation

EBITDA margin, at 18.7%, is expected to beat our previous FY17 forecast by 80bp, giving us increased confidence to assume terminal EBITDA margin of 20.0% (previously 19.5%). This helps to drive a DCF valuation of 344p/share, up from 243p. Our peer-based comparison implies a similar valuation of 345p.

13 September 2017

Price	**307.50p**
Market cap	**£179m**

Net cash (£m) at 31 August 2017	14.2
Shares in issue	58.1m
Free float	42%
Code	TUNE
Primary exchange	AIM
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	6.0	6.0	89.2
Rel (local)	4.9	7.3	70.9
52-week high/low		336.5p	157.5p

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	November 2017

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Edison profile page

Full year pre-close: Material profit upgrade

Revenue and profit outperformance

Focusrite has had an excellent second half. Revenue was up c 21.6% for the year, or 13% on a constant currency basis to approximately £66m, implying c 16% revenue growth in the second half. However, the fact that both revenue and profit are now guided ahead of the first half means that second-half pre-tax profit of £4.6m is considerably ahead of our forecast, raising our expected pre-tax profit for the full year by £0.7m, or 8.8%, to £9.2m.

Exhibit 1: Summary of forecast beat

£'000	H116	H216	FY16	H117	H217	FY17e
Revenue - forecast	25.9	28.4	54.3	32.0	32.8	64.9
Revenue - pre-close					34.0	66.0
Adjusted EBITDA - forecast	4.8	5.4	10.2	6.1	5.5	11.6
Adjusted EBITDA -pre-close					6.2	12.4
Pre-tax profit - forecast	3.0	4.7	7.7	4.6	3.9	8.5
Pre-tax profit - pre-close					4.6	9.2

Source: Focusrite, Edison Investment Research

Our forecast was understandably set at lower levels than the first half because, although Focusrite is not a markedly seasonal business, the first half had benefited significantly from the launch of the second-generation Scarlett range in June 2016. There was also demand strength for the Novation division's core Launchpad product, and we questioned whether this would continue as strongly in the second half.

The reasons for the strong H2 result relate both to revenue and margin:

- Improved sales of product: although second half revenue is only slightly higher than we expected, we understand that the improvement reflects a weighting of sales growth towards higher-margin product areas, such as Focusrite's professional ranges and Novation products, while discounts have been actively managed.
- Foreign exchange benefits: over 50% of Focusrite sales and close to all its cost of sales are denominated in US dollars (or related currencies), which gives the company an effective natural hedge against the currency. However, as around 25% of its revenue is in €, of which 75% is hedged, there is a small positive exposure to the €. This means that the strength of the € against sterling in the second half, compared to our cautious forecast, has driven some margin benefit.
- Gross margin management: as well as the margin benefits of sales mix mentioned above, management continues to manage margin actively. This includes a tough attitude to discounts allowed to resellers and continuous review of pricing.

As a result of these factors working in combination, the over-performance is reflected in a net improvement in gross margin of one whole percentage point from the 38.0% we had forecast to the 39.0% we now forecast for FY17.

The company has not commented on operating costs, interest or tax and we leave these items materially unchanged in our upgraded FY17 forecast.

Exhibit 2: Revised FY17 forecast

£'000	H116	H216	FY16	H117	H217e	FY17e	H1 y-o-y	H2 y-o-y	FY y-o-y
Total revenue	25,880	28,421	54,301	32,020	34,003	66,023	23.7%	19.6%	21.6%
Gross profit	10,305	10,557	20,862	12,855	12,894	25,749	24.7%	22.1%	23.4%
Gross margin (%)	39.8%	37.1%	38.4%	40.1%	37.9%	39.0%	0.3%	0.8%	0.6%
Adjusted EBITDA	4,821	5,428	10,249	6,131	6,242	12,373	27.2%	15.0%	20.7%
Adjusted EBITDA margin (%)	18.6%	19.1%	18.9%	19.1%	18.4%	18.7%	0.5%	-0.7%	-0.1%
Operating profit	3,692	3,985	7,677	4,571	4,613	9,184	23.8%	15.8%	19.6%
Pre-tax profit	2,969	4,694	7,663	4,599	4,623	9,222	54.9%	-1.5%	20.3%
EPS (p)	4.6	6.9	11.4	7.0	6.9	13.9	52.2%	0.6%	21.6%
Net cash	3,952	5,606	5,606	9,391	14,204	14,204	137.6%	153.4%	153.4%

Source: Focusrite, Edison Investment Research

Cash over-performance

Focusrite has ended its financial year with net cash of £14.2m, up from £5.6m at August 2016 and £9.4m at February 2017.

Representing net cash inflow of £8.6m compared with an outflow of £0.6m in FY16, this is a much stronger cash performance than the £5.2m we had forecast. In fact, it is 6% higher than net profit after tax for the year. This is largely the result of better working capital management, and specifically, we understand, inventory management.

Strong trading performance also naturally feeds into the cash flow, but the effect of strong demand on working capital is to run down inventory on hand to lower than planned levels. It would not be surprising to see a slight unwinding of this position in FY18.

Margin gains should be sustainable into FY18

Given the existing sales mix, Focusrite's culture of margin management, and in the absence of an extreme sterling recovery against the €, we assume FY17 gross margin of 39.0% can be improved in FY18e to 39.2%, resulting in a 5.7% upgrade to our PBT and EPS forecast. We assume a £3m improvement to our net cash forecast, reflecting the profit over-performance for both years, but allowing for some necessary restocking.

Exhibit 3: Changes to forecasts

Year end August	FY17e			FY18e		
(£m)	Old	New	% change	Old	New	% change
Revenues	64.9	66.0	1.8%	70.5	71.8	1.8%
Gross profit	24.7	25.7	4.4%	27.0	28.1	4.2%
Gross margin (%)	38.0%	39.0%	1.0%	38.3%	39.2%	0.9%
Adjusted EBITDA	11.6	12.4	6.4%	12.6	13.2	4.4%
Adjusted EBITDA margin (%)	17.9%	18.7%	0.8%	17.9%	18.4%	0.5%
Normalised operating profit	8.4	9.2	8.8%	9.1	9.7	5.8%
Normalised PBT	8.5	9.2	8.8%	9.2	9.7	5.7%
Normalised EPS (c)	12.8	13.9	8.8%	13.9	14.6	5.7%
Net cash	10.8	14.2	31.1%	15.2	18.1	19.0%

Source: Edison Investment Research

Valuation

Although Focusrite's market remains technical and competitive, the company continues to show independent growth characteristics and has strengthened its leadership credentials. 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 relevant smaller companies on near-term earnings expectations.

DCF valuation of 344p

We value Focusrite using a DCF projection which extends our published forecast using similar revenue growth and margin assumptions for a further two years, and then out to 10 years on consistent growth assumptions, fading in the last three years to a terminal rate of 2%. EBITDA margin, at 18.7%, is expected to beat our previous FY17 forecast by 80bp, giving us increased confidence to assume terminal EBITDA margin of 20.0% (previously 19.5%). In addition, our valuation has been moved up by the higher cash base now established for FY17 and the fact that our DCF therefore now includes a further trading year. We assume an equity-only cost of capital remaining at 8.4% (risk-free rate 2%, risk premium 7%, beta 0.9), resulting in a valuation of 344p/share, of which 193p is in the terminal value (previous valuation: 243p). This would put the shares on a FY18e P/E of 23.5x and EV/EBITDA of 13.8x. Varying the cost of capital and the terminal growth assumption would give the following ranges:

Exhibit 4: DCF assumption scenario analysis (p)

	Terminal growth rate				
Cost of capital	0.0%	1.0%	2.0%	3.0%	4.0%
10.0%	240	253	270	292	321
9.0%	270	289	312	343	387
8.0%	308	334	368	416	487
7.0%	358	395	447	525	655

Source: Edison Investment Research

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

Exhibit 5: Growth and margin assumption scenario analysis

		Sales growth 2019-2020e				
		6%	7%	8%	9%	10%
Margin change pa 2021-24e	0.5pp	321	344	369	396	424
	0.4pp	310	332	356	382	409
	0.3pp	298	320	344	368	395
	0.2pp	287	308	331	354	380
	0.1pp	276	296	318	341	365

Source: Edison Investment Research

Peer group valuation of 345p

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.

Exhibit 6: Peer valuation

All calendarised to August	Country	Mid price (ccy)	Mkt cap (ccy) m	Mkt cap £m	P/E 2017e	P/E 2018e	EV/EBITDA 2017e	EV/EBITDA 2018e
Universal Electronics	US	57.0	821	621	18.2	14.4	9.8	8.7
Tivo	US	18.1	2,207	1670	10.8	8.1	9.2	7.4
Morgan Adv. Materials	UK	298.0	850	850	13.9	12.4	7.2	6.9
Photo-Me International	UK	166.5	627	627	18.1	17.2	8.8	8.1
Oxford Instruments	UK	1121.0	643	643	23.2	20.9	13.9	14.1
Bang & Olufsen	DK	131.5	5,680	693	N/A	94.9	17.6	12.0
XP Power	UK	2620.0	504	504	19.6	18.8	12.8	12.3
Avid Technology	US	4.3	175	133	12.5	17.8	7.0	6.9
Gooch & Housego	UK	1336.0	327	327	28.4	24.6	15.9	13.8
Tt Electronics	UK	237.5	386	386	21.0	19.5	9.4	10.4
Dialight	UK	719.0	234	234	20.4	14.5	9.2	6.9
Quixant	UK	427.5	282	282	27.8	24.2	20.8	18.1
Judges Scientific	UK	1907.5	117	117	17.7	15.9	12.1	11.1
B&C Speakers	IT	11.8	130	118	19.0	N/A	N/A	N/A
Trakm8 Holdings	UK	92.5	33	33	33.0	12.8	15.1	7.8
Gear 4 Music (Hldgs)	UK	805.0	168	168	87.5	78.2	52.2	41.1
Average					**24.8**	**26.3**	**14.7**	**12.4**
Focusrite	UK	314.0	182	182	22.2	21.4	13.6	12.5
Premium/(discount)					**-10.4%**	**-18.4%**	**-7.7%**	**0.6%**

Source: Bloomberg. LSE subsectors: Electrical Components & Equipment, Computer Hardware, Recreational Products; Retail: relevant audio/video companies from US and European markets. Market cap £25m-2bn. Note: Outliers excluded from table. Prices as at 11 September 2017. N/A: data not available.

For the year to August 2017, Focusrite trades at an average 10.4% P/E and a 7.7% EV/EBITDA discount to the group. For FY18e it trades at an 18.4% discount and a 0.6% premium respectively. Adjusting to average peer multiples values Focusrite shares at 369p on a P/E basis and 320p on an EV/EBITDA basis, a blend of 345p, which is close to our DCF valuation.

Exhibit 7: Financial summary

£'k	2015	2016	2017e	2018e	2019e
31-August	IFRS	IFRS	IFRS	IFRS	IFRS
INCOME STATEMENT					
Revenue	48,029	54,301	66,023	71,798	77,541
Cost of Sales	(29,381)	(33,439)	(40,274)	(43,653)	(47,145)
Gross Profit	18,648	20,862	25,749	28,145	30,396
EBITDA	9,302	10,249	12,373	13,188	14,213
Normalised operating profit	7,024	7,677	9,184	9,675	10,228
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	9,184	9,675	10,228
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	9,222	9,715	10,273
Profit Before Tax (reported)	6,484	7,126	9,222	9,715	10,273
Reported tax	(1,022)	(870)	(1,107)	(1,166)	(1,534)
Profit After Tax (norm)	6,166	6,793	8,116	8,549	8,738
Profit After Tax (reported)	5,462	6,256	8,116	8,549	8,738
Minority interests	0	0	0	0	0
Discontinued operations	0	0	0	0	0
Net income (normalised)	6,166	6,900	8,116	8,549	8,738
Net income (reported)	5,462	6,256	8,116	8,549	8,738
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	15.0	15.5	15.9
EPS - diluted, normalised (p)	10.5	11.8	13.9	14.6	15.0
EPS - basic reported (p)	10.4	11.8	15.0	15.5	15.9
Dividend (p)	1.80	1.95	2.25	2.40	2.55
Revenue growth (%)	17.2	13.1	21.6	8.7	0.0
Gross Margin (%)	38.8	38.4	39.0	39.2	39.2
EBITDA Margin (%)	19.4	18.9	18.7	18.4	18.3
Normalised Operating Margin	14.6	14.1	13.9	13.5	13.2
BALANCE SHEET					
Fixed Assets	5,264	6,367	7,482	8,760	9,949
Intangible Assets	3,941	4,792	5,570	6,669	7,739
Tangible Assets	1,323	1,575	1,912	2,092	2,210
Investments & other	0	0	0	0	0
Current Assets	22,766	28,191	34,072	40,294	47,254
Stocks	8,633	11,361	9,000	10,166	12,916
Debtors	7,737	11,224	10,869	12,016	12,978
Cash & cash equivalents	6,173	5,606	14,204	18,112	21,360
Other	223	0	0	0	0
Current Liabilities	(8,809)	(9,256)	(8,040)	(8,541)	(9,376)
Creditors	(8,406)	(8,612)	(7,396)	(7,897)	(8,529)
Tax and social security	(403)	(644)	(644)	(644)	(847)
Short term borrowings	0	0	0	0	0
Other	0	0	0	0	0
Long Term Liabilities	(743)	(282)	(332)	(403)	(472)
Long term borrowings	0	0	0	0	0
Other long term liabilities	(743)	(282)	(332)	(403)	(472)
Net Assets	18,478	25,020	33,182	40,111	47,355
Minority interests	0	0	0	0	0
Shareholders' equity	18,478	25,020	33,182	40,111	47,355
CASH FLOW					
Op Cash Flow before WC and tax	9,302	10,249	12,373	13,188	14,213
Working capital	(1,689)	(6,009)	2,000	(2,312)	(3,080)
Exceptional & other	(591)	(417)	600	(0)	(0)
Tax	(838)	(165)	(1,107)	(1,166)	(1,534)
Net operating cash flow	6,184	3,658	13,867	9,710	9,599
Capex	(3,559)	(3,675)	(4,090)	(4,519)	(4,966)
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)	8,598	3,909	3,248
Opening net debt/(cash)	(3,803)	(6,173)	(5,606)	(14,204)	(18,112)
FX	0	0	0	0	0
Other non-cash movements	0	0	0	0	0
Closing net debt/(cash)	(6,173)	(5,606)	(14,204)	(18,112)	(21,360)

Source: Focusrite, Edison Investment Research

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