

Focusrite

Tuning up

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.

Full-year pre-close statement

Consumer electronics

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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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 | | | | | 32.8 | 64.9 |
| Revenue - pre-close | 25.9 | 28.4 | 54.3 | 32.0 | 34.0 | 66.0 |
| Adjusted EBITDA - forecast | | | | | 5.5 | 11.6 |
| Adjusted EBITDA -pre-close | 4.8 | 5.4 | 10.2 | 6.1 | 6.2 | 12.4 |
| Pre-tax profit - forecast | | | | | 3.9 | 8.5 |
| Pre-tax profit - pre-close | 3.0 | 4.7 | 7.7 | 4.6 | 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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