

# Focusrite

Final results

## Results exceed, strategy evolves

Focusrite, which already has market leadership in niche product areas, is evolving its strategy, to set up new brands targeting the professional interface and app markets. Focusrite has beaten our FY17 forecasts with 30% earnings growth, and we upgrade for the third time this year. With its attractive c 85% overseas revenue structure, we believe Focusrite is well placed in the short and medium term to sustain its independent strength.

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	25.5	16.6	0.6
08/17	66.1	9.5	14.8	2.7	20.4	12.3	0.9
08/18e	72.7	10.0	15.3	3.0	19.7	11.7	1.0
08/19e	78.6	10.6	15.9	3.3	19.0	10.9	1.1

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

## FY17 earnings beat with vibrant US growth

FY17 EPS grew by 30%, beating our forecast by 6%. Revenue grew 21.6% (13.5% at constant currency), with growth across both brands and in all regions, but led by the US region (+31%, 18% at constant currency) and the Novation segment (+38%). EBITDA grew 27.9% and net cash was at £14.2m (£5.6m at August 2016).

## Evolution of strategy: Two new brands

This is the first report under new CEO Tim Carroll, an industry professional with career history at US competitor Avid. The strategy is evolving to emphasise actions to grow the customer base, increase lifetime value of customers, and expand into new markets. Two new brands are being launched: Focusrite Pro, to target the professional interface market, and Ampify, to develop the app market.

## International markets: Structurally well-placed

Focusrite, though a small company, is similar to the FTSE100 in that c 85% of its revenues are in non-sterling currencies. Weaker sterling helped these results and will continue to benefit FY18. Beyond that, and accepting the potential turbulence of Brexit, we see Focusrite as structurally well placed in the medium term with growing traction in international markets such as the US and Far East.

## Forecast upgrade

We are upgrading our forecast FY18 EPS by 5.1% (we previously upgraded in September and May). Despite investment in the organisation, particularly in the two new brands and international marketing, we still upgrade EBITDA by 4.8% and PBT by 3.1%. In FY19 we expect similar effects to result in upgrades of 2.8% to PBT and 6.3% to EPS.

## Valuation: Raised to 363p

Our DCF valuation is 363p/share, which would put the shares on an FY18e P/E of 23.7x and EV/EBITDA of 14.2x. A comparison against peers, taking into account 24p of excess cash, suggests a slightly lower level of 338p.

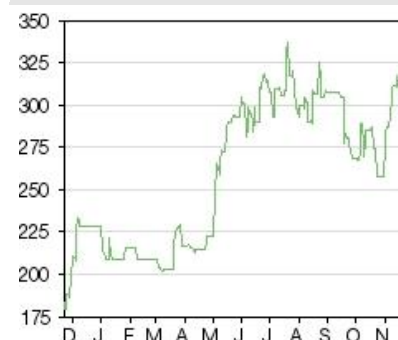
## Consumer electronics

21 November 2017

**Price** 302p  
**Market cap** £175m

Net cash (£m) at August 2017	14.2
Shares in issue	58.1m
Free float	40%
Code	TUNE
Primary exchange	AIM
Secondary exchange	N/A

## Share price performance



%	1m	3m	12m
Abs	10.4	(1.3)	83.3
Rel (local)	12.3	(2.3)	66.8
52-week high/low		336.5p	165.0p

## 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

AGM statement	January 2018
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## Investment summary

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### Company description: Global music and audio products group

Focusrite is a global music and audio products group supplying hardware and software products used by professional and amateur musicians. Its products fall into two main brand groups, Focusrite and Novation. The Focusrite brand group (around two-thirds of the business) produces audio interfaces. The Novation brand (around one-third of the business) focuses on hardware and software for creating and playing electronic music. The strategy is to pursue growth through innovation, disruption and expansion, with three core processes: growing the core customer base, increasing the lifetime value of customers, and expanding into new and high potential markets.

### Financials: FY17 earnings beat and upgrade

FY17 earnings per share were 14.8p, up by 29.8%, and beat our 13.9p forecast by 6%. Revenue grew 21.6% (13.5% at constant currency) to £66.1m, with growth across both brands and in all regions. Adjusted EBITDA was up 27.9% at £13.1m and pre-tax profit before was up by 33.5% to £9.5m. The main Focusrite ranges all grew market share. Novation grew by 37.8%, led by a significant strengthening of Launchpad demand. Currency helped margins to strengthen 1.5ppts on the year to 39.9%. Net cash finished at £14.2m, up from £5.6m at August 2016. We are upgrading our forecast FY18 EPS by 5.1% and FY19 by 6.3%.

### Valuation: DCF valuation of 363p reflects strong positioning

Focusrite has leadership share in a specialist market. Its success in growing its earnings and dividend stream depends on its ability to remain at the forefront of a competitive technical field, marketing its products successfully to a demanding user group. We see the current strategy as helpful in expanding the company's product offering to new market segments and developing its international markets. We use a DCF projection to place a value of 363p (previously 344p) on the longer-term income stream available to investors. That would put the shares on an FY18e P/E of 23.7x and EV/EBITDA of 14.2x. We also consider valuation in relation to a peer group of smaller companies on near-term earnings expectations, albeit there are few close peers. Focusrite trades at an average P/E and EV/EBITDA discount to the group. We now adjust the P/E measure to take account of 24p of excess cash, suggesting a slightly lower level of 338p.

### Sensitivities: Demand, technology, currency management

Sensitivities include the cyclical nature of consumer demand in Focusrite's ultimate markets and the continued technical execution of excellent new products. Our forecasts assume that the company will continue to identify and exploit new technological and product opportunities that build its share of the market and monetise its substantial investment in R&D. Focusrite has a currency risk on its c 25% euro-denominated revenue although it has a substantial natural hedge to the US dollar; however, potential effects of Brexit on currency and movement of goods are unknown. Focusrite has dependence on a small number of suppliers, key resellers and distributors, so that the interruption of such relationships could be damaging. The achievement of the company's plans also depends on the knowledge, judgments and experience of a small management team, so that continuity is important and unexpected change could bring risks (we note the transition to the new CEO has been executed smoothly).

## Company description: Products for music making

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Focusrite is a global music and audio products group supplying hardware and software products used by professional and amateur musicians. Its products, which fall into two main brand groups, enable and facilitate the high-quality production of music. The strategy relates to growth through innovation, disruption and expansion. It has been more specifically defined by the incoming CEO Tim Carroll as three processes:

1. **Grow the core customer base.** This encompasses new product offerings as well as next-generation versions and enhancements to the current portfolio. It includes customer-relevant hardware and software to enable the creative process. It also relies on new disruptive solutions that increase the addressable market.
2. **Increase lifetime value of customers.** Here the focus is on building a connected experience to tie the company's solutions together. That includes add-on software tools and content, and participation in more of the traditional value chain.
3. **Expand into new and high potential markets.** Focusrite will leverage its current portfolio and IP to enter new markets. It will continue to expand into geographies with large potential. Acquisitions will be considered if the right opportunities arise.

## Two faces of music production

The company has two main divisions: the Focusrite brand group (67% of FY17 revenue) covers audio recording equipment; and the Novation brand group (28% of FY17 revenue) focuses on hardware and software for creating and playing electronic dance music (EDM) and other types of music. Focusrite also has a smaller Distribution division, which acts as UK distributor for third-party brands.

What the brands have in common is an objective to serve musicians at all levels, and in particular help musicians who may not have been professionally trained to realise their creative potential by creating high-quality music with a minimum of technical complication.

Focusrite aims to provide the best quality product at each price point. Its products range from those designed for budget personal spend levels to the highest professional specifications, with consistent high standards throughout. Product ranges are continuously refreshed to remain at the forefront of the market. Its markets are fully international, with FY17 revenue split 42% US, 38% EMEA and 20% RoW.

## History: High-quality origins

Focusrite's origins can be traced to the iconic ISA 110 pre and EQ module designed by legendary sound engineer Rupert Neve for Sir George Martin in 1985, which formed the basis of a family of state-of-the-art studio consoles in the 1980s and 1990s, used by Frank Sinatra, The Mamas and The Papas, Quincy Jones and Nat King Cole. Phil Dudderidge, originally a sound engineer with Led Zeppelin, having sold his own audio business, acquired the Focusrite business in 1989. The early history is documented on [YouTube](#). The Novation business was acquired in 2004. The 2014 IPO was by way of a vendor placing of 17.8m shares at 126p: its main effect was to bring in institutional investors and reduce Phil Dudderidge's holding from 77% to 52%. No new funds were raised.

## The business today

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### The Focusrite brand group (67% of revenue)

The main brand categories are:

- **Scarlett:** an industry-leading audio interface, generating about two-thirds of the division's revenue. Scarlett serves the market of individual musicians seeking to record their work. In line with the company's quality values, Scarlett optimises sound quality, response speed and ease of operation, offering studio-quality analogue to digital conversion at an accessible price point. The brand was refreshed with a second-generation launch of eight products in June/July 2016, reflecting design improvements, embedded technology and software giving enhanced performance. For instance, the second-generation Scarlett 2i2, at \$149, has a 2-in/2-out USB interface and a 106dB dynamic range. It features an upgraded instrument input of +22dBu (formerly 14dBu), 24-bit audio with sample rates up to 192kHz (previously 96kHz) and direct latency-free monitoring. Quality is reflected in the aluminium body and metal control knob. Scarlett price points are US\$99-499, with larger models having additional inputs and outputs.
- **Clarett:** a professional range with lower noise and higher gain characteristics than Scarlett. It is centred on the industry-specific Thunderbolt connection protocol, enabling faster data transfer and low latency. Models (2Pre, 4Pre, 8Pre, 8PreX, and the newly launched OctoPre) span two, four and eight preamps, have a full aluminium finish and are priced at US\$499-1,199. Clarett moves on from the previous professional range, Saffire.
- **Other brand ranges:** the iTrack range allows users to connect and record using mobile technology such as the iPhone, and retails from as little as US\$19.99 (iTrack Pocket) to US\$149.99 (iTrack Dock).

### Novation brand group (28% of revenue)

Novation's products are instruments and software for making electronic music, the fastest-growing music creation segment.

There are four categories:

1. **Launchpad:** Novation's leading brand is a disruptive product that created a new market from 2009. Unlike traditional synthesiser keyboards, it has a grid of lighted keys, used to create bass, drums and melody. Launchpad featured in *Pop Culture*, a YouTube mash-up created by the 17-year old Hugo Pierre Leclercq (aka Madeon) in July 2011. The [video](#) went viral with 31 million views. Launchpad now has a wave of users who create cover versions of music tracks. For instance, the [TOP 10 Best Launchpad Covers of 2016](#) has 65m views on YouTube. Supported by industry-standard software Ableton, Launchpad has been extended to a family including Launchpad Pro and Launchpad Mini. Price points are US\$99-299.
2. **Synthesisers:** these were Novation's original products. Current models are radically compressed compared with early designs and are typically a portable unit with a short keyboard. There are three ranges: Bass Station II (analogue monosynth), MiniNova (digital microsynth) and UltraNova (analogue-modelling synth), priced at US\$399-599.
3. **Keyboard controllers:** these transmit MIDI data to synthesisers, computer software synthesisers, or hardware or software sequencers. Novation's keyboard controllers integrate with Ableton or other studio software to create sounds. Products include:
  - Launchkey Mini, a compact 25-note MIDI keyboard controller with 16 additional pads;
  - Launchkey, a MIDI controller with 25, 49 or 61 keys with pads, knobs and faders;
  - Impulse, a higher-spec controller in the same note sizes with fully assignable controls; and
  - SL MkII, an advanced professional range with the same range of note sizes.

4. **Groovebox/Circuit:** launched October 2015, a standalone grid-based portable unit capable of producing its own synth, drum machine and sample sequences through its own speaker, as well as connecting to other hardware.

## New brands: Focusrite Pro and Ampify

Focusrite is setting up two brands targeting opportunities in the high-end interface and app segments:

### 1. Focusrite Pro <https://pro.focusrite.com/category/audio-interfaces>

- Focusrite Pro is a brand group that will specialise in the higher-priced B2B space. With origins in the personal music-making space, the Focusrite operation has had increasing success with its high-end professional products such as Red. Opportunities are expanding with applications in recording studios, film, TV and radio studios, live sound rigs, studios, houses of worship, audio distribution installations, and postproduction environments. Such commercial communications are rapidly developing from technologies using standard networking or fibre-optic cable to Ethernet cable, which has hugely increased functionality per unit cost. Customers include NBC, the BBC and Microsoft. There is a specific opportunity from the massive upsurge in made-for-TV multi-series blockbusters.
- Management recognises that the marketing skills required to fully exploit this area are different to those required for its core product ranges such as Scarlett. The set-up of the Focusrite Pro team has marks an investment in an incremental product area and in appropriate process.

The main product ranges falling under the new brand are:

- **Red:** The Red range offers professional quality digital conversion, remote-controlled microphone preamplifiers, and built-in monitor controls coupled with very low latency Pro Tools, Thunderbolt and Dante interface technology. With very low noise, low distortion and ultra-linear design, they give extremely accurate representation of original acoustics. The low-latency, highly reliable drivers provide seamless integration with many DAWs while the DigiLink Mini ports allow connection directly to Pro Tools|HDX, Pro Tools|HD native and older Pro Tools|HD TDM systems. Price points are US\$2,499-3,499.
- **RedNet:** RedNet is a scalable, near zero latency (150-500 microseconds) audio distribution system that can be used to expand I/O channel count, interface digital components, and/or bridge between Pro Tools|HD or MADI, and the Dante audio network. Price points for RedNet models are US\$399-3,599.

### 2. Ampify <https://ampifymusic.com>

Ampify marks the formalisation of the company's initiatives in app development based on its Novation sound generation technology. There are three app products that now have over 7.5m downloads and 550k active users. They are all structured as a freemium model that is free to load and has priced add-on features.

- a. **Launchpad:** the original app venture, launched in 2013. Launchpad allows the user to create and remix electronic beats and music on the iPad or iPhone, and to record and share performances.
- b. **Blocs Wave:** a more sophisticated product launched in 2016 as a priced product, but now also moved to the freemium model. Blocs Wave is designed to make and record new music quickly, building up new ideas and using real-time loop recording.
- c. **Groovebox:** a flexible and creative app designed to turn ideas into full songs. Groovebox uses 'Song Sections' to help the user build and arrange ideas. Tracks can be structured by adding, duplicating, moving and deleting sections. Groovebox is also a freemium offer.

The company has seen an acceleration in the rate of downloads with 2.8m in the year, including a marked pick-up in interest from China. Margins are higher than for physical products, although third-party origination costs have been incurred. However, as the venture gains scale these can be increasingly brought in-house. The music creation app space is intensely competitive and barriers to entry are relatively low; however, the products hold their position in the top 10 Apple music creation apps.

## **Distribution (5% of revenue)**

The company is the UK distributor for the leading brands KRK (studio monitors) and sE Electronics (microphones). These are adjacent areas technically but are not currently growing.

## **Market and competition**

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The global music instrument and pro audio wholesale market was £2.7bn in 2013, according to *Music Trades* magazine (source: admission document), growing at c 2% pa. However, that market is disparate and fragmented, including conventional instruments and traditional technology, as well as electronic technologies relevant to Focusrite. At the time of the IPO, management estimated the addressable market for its portfolio was c £450m, being £250m in the recording segment, £100m in the EDM segment and £100m in the commercial segment. Against this, and allowing for market growth, FY17 revenue represents a c 15% share. In addition, Focusrite's five-year revenue CAGR of 21% is considerably higher than estimated growth in the market as a whole.

Significant competitor brands for the Focusrite division are PreSonus and Apogee (vs Scarlett), Avid Pro Tools and Universal Audio Apollo (vs Clarett), and Avid HD and Apogee Symphony (vs RedNet). Launchpad competes against Ableton Push and Akai APC Mini ranges. Management estimates a c 50% share of the mass interface market, 17% of the semi-professional Thunderbolt market and 2-3% of the commercial market. According to management's US market analysis, the company is number one in the overall interface market, and management believes the company is in the top three across Novation's markets.

It is difficult to define market share in the app market, with its lower barriers to entry. However, the Launchpad app has generated over 7.5m downloads to date, helped by, and helping, the strength of the Novation brand. We believe Novation's ability to add advanced features to the Blocs Wave app will be key in this fast developing market.

## **Management**

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The board is headed by Executive Chairman Phil Dudderidge, who has a lifetime of sound engineering experience. Tim Carroll was appointed CEO effective January 2017; his substantial career was with Avid Technology Inc. where he was most recently vice president with responsibility for audio products. Jeremy Wilson, CFO, formerly of Regeneris, DHL and Electrocomponents, was appointed in 2014. Biographies are on page 12.

The senior management team has experience in all relevant product and market areas. Most managers are musicians as well as being qualified technically for their roles, and are passionate supporters of the strategy. The culture is entrepreneurial and opportunistic.

Although the chairman is a 52% shareholder, he remains actively engaged with other shareholders, and the board is also advised by two experienced non-executive directors: David Bezem, an investment banker formerly at Altium Corporate Finance, and Paul Dean, formerly group finance director of Ultra Electronics.



## Sensitivities

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**Product quality:** Focusrite's market leadership is based on the technical quality of its products, including updates to its ranges over time. It has well-developed testing and product review capabilities; nevertheless, a product issue requiring a major recall, for example, would be a negative event. We believe that product excellence will continue to be a positive for the company.

**Technological opportunities:** our forecasts assume the company will continue to identify, exploit and market new product opportunities that build its share of market, and continue to monetise the investment in R&D. If instead the initiative were grasped by competitors, growth could be affected. We note that the company is actively expanding its product areas with new brand groups Focusrite Pro and Ampify.

**Consumer demand:** the company is subject to cyclical demand in its consumer markets. Even for products aimed at the B2B market, demand is also ultimately driven by consumers. However, exposure to a range of international markets provides a measure of protection.

**Currency risk and Brexit:** c 60% of Focusrite's revenue and c 100% of its cost of sales are denominated in US dollars (or related currencies), which gives the company an effective natural hedge against the currency. However, around 25% of its revenue is in euros. Focusrite uses forward contracts to lock in budget certainty against 75% of euro exposures; however, since it reports in sterling it has exposure to the euro, and to the extent the natural hedge is approximate, to the US dollar. On this basis, a 10% change in the value of US dollar would have little profit effect. However, a 10% movement in the euro would affect revenue by £1.6m. In addition, the effects of Brexit, both on currency and on the movement of goods into and out of the UK, are currently being assessed within Focusrite.

**Management team:** in its technical product area, the achievement of the company's plans depends on the knowledge, judgments and actions of the management team. The team has a uniquely relevant blend of experience and any unexpected changes could affect the realisation of its plans. We note the transition to the new CEO has been executed smoothly.

**Dependence on trade relationships:** Focusrite has dependence on a small number of suppliers, key resellers and distributors, so that an interruption of such relationships could be damaging. We note that the company has started to distribute via Amazon and directly online, which, while still small in scale, potentially reduces its absolute dependence on third parties.

## Financials

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### Results for the year to August 2017

Earnings per share were 14.8p, up by 25.5%, and beat our 13.9p forecast by 6%. Revenue grew 21.6% (13.5% at constant currency) to £66.1m, with growth across both brands and in all regions. Adjusted EBITDA was up 27.9% at £13.1m and pre-tax profit was up by 24.1% to £9.5m

**Exhibit 1: Full year results**

£000s	H116	H216	FY16	H117	H217	FY17	H1 y-o-y	H2 y-o-y	FY y-o-y
Revenue by product type									
Focusrite	16,946	20,617	37,563	20,856	23,696	44,552	23.1%	14.9%	18.6%
Novation	7,287	6,396	13,683	9,604	9,258	18,862	31.8%	44.7%	37.8%
Distribution	1,647	1,408	3,055	1,560	1,081	2,641	-5.3%	-23.2%	-13.6%
<b>Total</b>	<b>25,880</b>	<b>28,421</b>	<b>54,301</b>	<b>32,020</b>	<b>34,035</b>	<b>66,055</b>	<b>23.7%</b>	<b>19.8%</b>	<b>21.6%</b>
Revenue by geography									
US	9,069	12,313	21,382	13,246	14,744	27,990	46.1%	19.7%	30.9%
Europe and Middle East	12,064	10,518	22,582	12,958	12,195	25,153	7.4%	15.9%	11.4%
Rest of World	4,747	5,590	10,337	5,816	6,317	12,912	22.5%	13.0%	24.9%
<b>Total</b>	<b>25,880</b>	<b>28,421</b>	<b>54,301</b>	<b>32,020</b>	<b>34,035</b>	<b>66,055</b>	<b>23.7%</b>	<b>19.8%</b>	<b>21.6%</b>
Gross profit	10,305	10,557	20,862	12,855	13,496	26,351	24.7%	27.8%	26.3%
Gross margin	39.8%	37.1%	38.4%	40.1%	39.7%	39.9%	0.3%	2.5%	1.5%
<b>Adjusted EBITDA</b>	<b>4,821</b>	<b>5,428</b>	<b>10,249</b>	<b>6,131</b>	<b>6,978</b>	<b>13,109</b>	<b>27.2%</b>	<b>28.6%</b>	<b>27.9%</b>
Adjusted EBITDA margin	18.6%	19.1%	18.9%	19.1%	20.5%	19.8%	0.5%	1.4%	1.0%
Operating profit	3,692	3,985	7,677	4,571	4,899	9,470	23.8%	22.9%	23.4%
<b>Pre-tax profit</b>	<b>2,969</b>	<b>4,694</b>	<b>7,663</b>	<b>4,599</b>	<b>4,913</b>	<b>9,512</b>	<b>54.9%</b>	<b>4.7%</b>	<b>24.1%</b>
EPS (p)	4.6	7.2	11.8	7.0	7.8	14.8	52.2%	8.0%	25.5%
Cash	3,952	5,606	5,606	9,391	14,174	14,174	137.6%	152.8%	152.8%

Source: Focusrite accounts, Edison Investment Research

**Focusrite division performance**

The main ranges Scarlett, Clarett and Red all grew in absolute and market share terms. Following its launch in June 2016, Scarlett 2nd generation traded particularly strongly, and consolidated its number one world position with market share now around 50%. Five new branded products were launched in the year.

**Novation division performance**

The Novation division grew by 37.8%, led by a significant strengthening of Launchpad demand, and with strong growth from Launchkey and synthesisers. Larger penetration from online distribution channels such as Amazon helped Launchpad volumes to grow 39%. These channels are making the product available to customers who are not habitual music equipment purchasers, for example parents buying a Christmas or birthday gift for their children. Three new products were launched including a new flagship synthesiser, Peak. This retails at \$1,299 compared with prices of \$400-600 for the existing synthesiser range, opening up access to the market of professional musicians, where it is achieving widespread adoption.

**Geographical performance and gross margin: Underlying strength and further currency enhancement**

Given that euro sales are around 25% of the total, and US and Far Eastern sales total 62%, some 85% of total revenue is in currencies other than pounds sterling. As a result, revenue was enhanced by sterling's weakness, although constant currency growth was also strong:

**Exhibit 2: Geographical revenue**

£000s	FY16	% of revenue	FY17	% of revenue	Growth	CC growth
US	21,382	39.4%	27,990	42.4%	30.9%	18%
Europe and Middle East	22,582	41.6%	25,153	38.1%	11.4%	6%
Rest of World	10,337	19.0%	12,912	19.5%	24.9%	12%
<b>Total</b>	<b>54,301</b>	<b>100.0%</b>	<b>66,055</b>	<b>100.0%</b>	<b>21.6%</b>	<b>13.5%</b>

Source: Focusrite, Edison Investment Research

The US is the company's largest market with 42% of total sales. It remains a key sales focus and the Los Angeles marketing office team is being further expanded, with a team of c 30. Europe has been affected by strong competition between major resellers. That competition resulted in growth that was lower than other regions though still ahead of industry averages. In the rest of the world,



strong Asia-Pacific sales were boosted by China, especially for Novation products, and the Hong Kong office has been fully established with five heads. Latin America and Canada both grew and are likely to be a focus for growth. Currency was also the main factor in gross margins that ended 1.5ppts up on the year at 39.9%.

### Cash: Strong performance reflecting inventory management

Net cash finished at £14.2m, up from £5.6m at August 2016 and £9.4m at February 2017. Net cash inflow of £8.6m compares with an outflow of £0.6m in FY16, and is identical to profit after tax. This is largely the result of better working capital management, and specifically inventory management assisted by strong demand, with stock holdings reduced from 124 days to 77.

### Forecasts: Significant upgrade

We are upgrading our forecast FY18 EPS by 5.1%. We upgrade revenue, based on underlying blended year-on-year increases of 8%, by 1.3%, and currency benefits increase our gross margin expectation by 2.4ppts to increase gross profit by 7.7%. Despite increases in expected organisational costs, particularly around the two new brands and the international marketing effort, that still results in a 4.8% upgrade to EBITDA and a 3.1% upgrade to PBT.

In FY19 we expect similar effects to result in upgrades of 2.8% to PBT and 6.3% to EPS.

<b>Exhibit 3: Changes to forecasts</b>						
£m	FY18e old	FY18e new	change	FY19e old	FY19e new	change
Revenues	71.8	72.7	1.3%	77.5	78.6	1.3%
Gross profit	28.1	30.3	7.7%	30.4	32.7	7.5%
Gross margin	39.2%	41.6%	2.4%	39.2%	41.6%	2.4pp
Adjusted EBITDA	13.2	13.8	4.8%	14.2	14.8	4.1%
Adjusted EBITDA margin	18.4%	19.0%	0.6%	18.3%	18.8%	0.5pp
Normalised operating profit	9.7	10.0	2.7%	10.2	10.5	2.8%
Normalised PBT	9.7	10.0	3.1%	10.3	10.6	2.8%
Normalised (diluted) EPS (p)	14.6	15.3	5.1%	15.0	15.9	6.3%
Net cash	18.1	17.6	-2.6%	21.4	20.6	-3.6%
Source: Edison Investment Research						

We also introduce our FY20 forecasts with an EBITDA growth forecast of 5.7% to £15.6m.

### Valuation: Well placed to retain market dominance

Though smaller than many other household electronics companies, 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. We believe the company is well placed to sustain this reputation over the medium term, and for this reason we use a DCF projection to place a value on 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.

### DCF valuation of 363p

Our DCF projection 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 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 363p/share (of which 227p is in the terminal value). That would put the shares on an FY18 P/E of 23.7x and EV/EBITDA of 14.2x. Varying the cost of capital and the terminal growth assumption would give the following ranges:

**Exhibit 4: DCF assumption scenario analysis (p)**

Cost of capital	Terminal growth rate				
	0.0%	1.0%	2.0%	3.0%	4.0%
10.0%	249	264	283	307	339
9.0%	282	302	329	363	412
8.0%	324	352	390	443	523
7.0%	378	419	477	563	708

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 FY21-27				
		4%	6%	8%	10%	12%
Terminal margin	23.0%	344	372	402	434	468
	22.0%	328	354	382	413	445
	21.0%	312	336	363	392	422
	20.0%	296	319	344	370	399
	19.0%	280	301	324	349	376

Source: Edison Investment Research

## Peer group comparison: Does not fully reflect excess cash

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.

**Exhibit 6: Peer valuation**

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	52.3	748	576	14.4	N/A	8.7	N/A
Tivo	US	17.7	2,160	2160	7.7	8.3	6.9	7.7
Morgan Adv. Materials	UK	322.3	920	920	13.4	12.4	7.3	7.0
Photo-Me International	UK	178.9	672	672	18.3	17.2	8.7	8.2
Oxford Instruments	UK	974.8	561	561	18.3	16.9	11.6	11.0
Bang & Olufsen	DK	137.8	5,961	714	N/A	25.6	12.6	9.3
XP Power	UK	3,408.0	655	655	22.7	21.3	14.8	14.1
Avid Technology	US	5.7	236	182	22.1	N/A	8.3	N/A
Gooch & Housego	UK	1,375.5	337	337	25.3	24.1	14.2	13.5
Dialight	UK	659.5	212	212	16.1	12.9	7.6	6.4
Quixant	UK	417.5	276	276	24.7	21.6	17.6	15.0
Judges Scientific	UK	1,942.5	119	119	15.6	15.0	10.6	9.3
B&C Speakers	IT	11.2	123	106	16.4	15.5	11.6	11.6
Trakm8 Holdings	UK	152.5	54	54	21.0	15.2	12.3	9.5
Gear 4 Music (Hldgs)	UK	732.5	153	153	71.4	54.4	38.6	30.8
<b>Average</b>					<b>22.0</b>	<b>20.0</b>	<b>12.7</b>	<b>11.8</b>
Focusrite	UK	314.0	182	182	20.5	19.7	12.2	10.9
<b>Premium/(discount)</b>					<b>-6.8%</b>	<b>-1.5%</b>	<b>-4.6%</b>	<b>-7.7%</b>

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 17 November 2017. N/A: data not available.

For the year to August 2018, Focusrite trades at an average 6.8% P/E discount and a 1.5% EV/EBITDA discount to the group. For FY19e it trades at a 4.6% and 7.7% discount, respectively. However, we note the now significant excess cash of £14.8m, 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 352p on a P/E basis and 323p on an EV/EBITDA basis, a blend of 338p, slightly below our DCF valuation.

**Exhibit 7: Financial summary**

	£000s	2015	2016	2017	2018e	2019e	2020e
Year end 31 August		IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
<b>INCOME STATEMENT</b>							
Revenue		48,029	54,301	66,055	72,715	78,564	84,850
Cost of Sales		(29,381)	(33,439)	(39,704)	(42,460)	(45,876)	(49,546)
Gross Profit		18,648	20,862	26,351	30,254	32,688	35,303
EBITDA		9,302	10,249	13,109	13,834	14,790	15,634
Normalised operating profit		7,024	7,677	9,470	9,963	10,515	11,037
Amortisation of acquired intangibles		0	0	0	0	0	0
Exceptionals		(704)	(537)	0	0	0	0
Share-based payments		0	0	0	0	0	0
Reported operating profit		6,320	7,140	9,470	9,963	10,515	11,037
Net Interest		164	(14)	42	40	45	50
Joint ventures & associates (post tax)		0	0	0	0	0	0
Exceptionals		0	0	0	0	0	0
Profit Before Tax (norm)		7,188	7,663	9,512	10,003	10,560	11,087
Profit Before Tax (reported)		6,484	7,126	9,512	10,003	10,560	11,087
Reported tax		(1,022)	(870)	(959)	(1,200)	(1,426)	(1,663)
Profit After Tax (norm)		6,166	6,793	8,553	8,803	9,135	9,424
Profit After Tax (reported)		5,462	6,256	8,553	8,803	9,135	9,424
Minority interests		0	0	0	0	0	0
Discontinued operations		0	0	0	0	0	0
Net income (normalised)		6,166	6,900	8,553	8,803	9,135	9,424
Net income (reported)		5,462	6,256	8,553	8,803	9,135	9,424
Basic average number of shares outstanding (m)		52.4	53.2	55.4	56.0	56.0	56.0
EPS - basic normalised (p)		11.8	13.0	15.4	15.7	16.3	16.8
EPS - diluted, normalised (p)		10.5	11.8	14.8	15.3	15.9	16.4
EPS - basic reported (p)		10.4	11.8	15.4	15.7	16.3	16.8
Dividend (p)		1.80	1.95	2.70	2.95	3.30	3.65
Revenue growth (%)		17.2	13.1	21.6	10.1	8.0	8.0
Gross Margin (%)		38.8	38.4	39.9	41.6	41.6	41.6
EBITDA Margin (%)		19.4	18.9	19.8	19.0	18.8	18.4
Normalised Operating Margin		14.6	14.1	14.3	13.7	13.4	13.0
<b>BALANCE SHEET</b>							
Fixed Assets		5,264	6,367	6,332	7,392	8,416	9,544
Intangible Assets		3,941	4,792	4,963	6,159	7,367	8,651
Tangible Assets		1,323	1,575	1,369	1,233	1,050	893
Investments & other		0	0	0	0	0	0
Current Assets		22,766	28,191	36,126	41,974	48,775	55,221
Stocks		8,633	11,361	9,000	9,888	12,569	13,574
Debtors		7,737	11,224	12,952	14,457	15,620	17,335
Cash & cash equivalents		6,173	5,606	14,174	17,629	20,586	24,312
Other		223	0	0	0	0	0
Current Liabilities		(8,809)	(9,256)	(8,663)	(9,116)	(9,899)	(10,466)
Creditors		(8,406)	(8,612)	(8,204)	(8,657)	(9,354)	(9,830)
Tax and social security		(403)	(644)	(459)	(459)	(545)	(636)
Short term borrowings		0	0	0	0	0	0
Other		0	0	0	0	0	0
Long Term Liabilities		(743)	(282)	(245)	(309)	(375)	(444)
Long term borrowings		0	0	0	0	0	0
Other long term liabilities		(743)	(282)	(245)	(309)	(375)	(444)
Net Assets		18,478	25,020	33,550	39,940	46,918	53,855
Minority interests		0	0	0	0	0	0
Shareholders' equity		18,478	25,020	33,550	39,940	46,918	53,855
<b>CASH FLOW</b>							
Op Cash Flow before WC and tax		9,302	10,249	13,109	13,834	14,790	15,634
Working capital		(1,689)	(6,009)	407	(2,606)	(3,147)	(2,243)
Exceptional & other		(591)	(417)	137	(0)	(0)	(0)
Tax		(838)	(165)	(633)	(1,200)	(1,426)	(1,663)
Net operating cash flow		6,184	3,658	13,020	10,028	10,217	11,727
Capex		(3,559)	(3,675)	(3,614)	(4,960)	(5,423)	(5,934)
Acquisitions/disposals		0	0	0	0	0	0
Net interest		6	(111)	(42)	40	45	50
Equity financing		0	172	258	0	0	0
Dividends		(314)	(976)	(1,138)	(1,653)	(1,882)	(2,118)
Other		53	365	84	0	0	0
Net Cash Flow		2,370	(567)	8,568	3,455	2,957	3,725
Opening net debt/(cash)		(3,803)	(6,173)	(5,606)	(14,174)	(17,629)	(20,586)
FX		0	0	0	0	0	0
Other non-cash movements		0	0	0	0	0	0
Closing net debt/(cash)		(6,173)	(5,606)	(14,174)	(17,629)	(20,586)	(24,312)
Source: Focusrite accounts, Edison Investment Research							

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**Revenue by geography (at FY17)**

**Management team**
**Executive Chairman & Founder: Phil Dudderidge**

Phil has a distinguished career in the professional audio industry, including working as Led Zeppelin's first dedicated live soundman. He set up RSD in 1971, building bespoke PA systems with custom-built mixing consoles. In 1973, Phil set up Soundcraft Electronics, a company specialising in live audio mixing consoles, which was sold to Harman International in 1988. Phil acquired the assets of Focusrite in 1989. Phil served as CEO of Focusrite from 1989 until he became chairman in 2012.

**Chief Executive Officer: Tim Carroll**

Tim was appointed CEO of Focusrite in January 2017 on the retirement of Dave Froker, the previous CEO. He has extensive sector-relevant management and sales experience, having enjoyed a distinguished career with Avid Technology Inc. Most recently, he was a vice-president with global responsibility for audio products. Previously, he was VP for worldwide audio sales (2008-15) and has held other senior sales roles since 1998. In his most recent position, he was responsible for all audio categories in Avid's executive committees and held senior management responsibility for the Audio Division. He is a professional musician by background, having attended the New England Conservatory of Music and having recorded and toured for nearly 20 years as a keyboard player before joining Avid.

**Chief Financial Officer: Jeremy Wilson**

Jeremy was appointed CFO of Focusrite in September 2014. He has prior public market experience in a number of finance roles. Most recently, Jeremy was CFO of Atex Group, a leading worldwide developer of content management and advertising software to the media industry. Previously, he was CFO at Regeneris, an AIM-listed support services business. Before his CFO roles, Jeremy held several senior finance roles at DHL Express (UK) and Electrocomponents. He qualified as a chartered accountant at KPMG in 1992.

**Principal shareholders**

	(%)
Philip Dudderidge and family	52.1
Schroder Investment Mgmt Group	8.5
Charles Stanley	6.1
Hargreave Hale	5.6
Focusrite employee benefit trust	4.4

**Companies named in this report**

KRK Systems, sE Electronics, PreSonus Apogee Electronics, Avid (AVID US), Universal Audio (UEIC US), Ableton, Akai Electric Co., Ultra Electronics (ULE LN), Guitar Center, Sweetwater Sound, Amazon.com (AMZN US), Atex Group, DHL, Electrocomponents (ECM LN), Tivo (TIVO US), Morgan Advanced Materials (MGAM LN), Photo-Me International (PHTM LN), Oxford Instruments (OXIG LN), Bang & Olufsen (BO DC), XP Power (XPP LN), TT Electronics (TTG LN), Quixant (QXT LN), Gear4music Holdings (G4M LN).

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