Focusrite

Interim results

Earnings growth despite market headwinds

Consumer electricals

Focusrite has delivered 23% H119 earnings growth, despite market headwinds, reflecting continued market share gains for its Focusrite ranges, a strong performance in Europe and 260bp gross margin improvement. The company is actively seeking opportunities to use its substantial £26m net cash balance, as reflected in the current valuation.

Year end	Revenue (£m)	PBT* (£m)	EPS* (p)	DPS (p)	P/E (x)	Yield (%)
08/17	66.1	9.5	14.8	2.7	33.0	0.6
08/18	75.1	11.3	17.5	3.3	27.9	0.7
08/19e	78.3	12.4	18.8	3.6	25.9	0.7
08/20e	82.1	12.7	19.1	3.7	25.6	0.8

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

H119: Solid earnings growth; substantial net cash

Against a challenging macro backdrop and record prior year comparatives, Focusrite delivered a solid H119 performance. Revenue growth of 4.1% to £40.4m (slightly ahead of the £40m pre-close guidance) benefited from sterling weakness against the US dollar, while 0.5% constant currency growth contributed to an impressive two-year stacked growth rate of 26%. The 260bp increase in the gross margin to 44.3% helped to drive 11.4% EBITDA growth, while underlying PBT was up 22.6% to £7.2m. Net cash has increased by £3.4m from the year end to £26.2m.

A mixed regional and divisional performance

Europe delivered robust sales growth of 21%, while in the US the company's decision to pass on the 10% import tariff in October protected gross profit while North American revenue declined by 11%. Divisionally, continued strong demand for Clarett and Scarlett led to 12% growth in the Focusrite division, more than offsetting a 14% decline in the Novation division. This was driven by weaker demand for Launchpad, following several years of robust growth, and is being addressed with a pipeline of new products over the next 18 months.

5% upgrade to PBT may prove too cautious

We leave our FY19 and FY20 revenue forecasts broadly unchanged while cautiously assuming a further 50bp uplift to the FY19e gross margin to 43.2%. This is below the margin achieved in H1 as a further increase in US tariffs to 25% is still a possibility.

Valuation: Assumes a return on net cash

On a DCF basis, the share price is slightly ahead of our updated valuation of 471p (vs 457p), which assumes 10% revenue growth for five years beyond our forecast, fading to 2% in perpetuity, a terminal EBITDA margin of 21% and an 8.4% cost of capital. However, it does not reflect the potential return on investment of Focusrite's excess cash. We calculate that the market is factoring in utilisation of excess cash at an attractive 12% post-tax ROCE.

30 April 2019

Price	**489p**
Market cap	**£284m**
Net cash (£m) at 28 February 2019	26.2
Shares in issue	58.1m
Free float	60%
Code	TUNE
Primary exchange	LSE
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	1.4	(2.2)	10.5
Rel (local)	(2.1)	(9.9)	10.8
52-week high/low		524p	364p

Business description

Focusrite is a global music and audio products group supplying hardware and software used by professional and amateur musicians, which enables the high-quality production of music.

Next events

Pre-close	September 2019
Final results	November 2019

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Focusrite is a research client of Edison Investment Research Limited

H119: Solid earnings growth; net cash for acquisitions

Focusrite has reported a solid first-half trading performance. Revenue increased by 4.1% to £40.4m, beating pre-close guidance of c £40m. On a constant currency basis, revenue grew by 0.5%, against record underlying growth of 26% in H118.

The company's swift action to raise prices in the US following the introduction of a 10% import tariff contributed 100bp to the 260bp improvement in the group gross margin to 44.3% (H118: 41.7%). The additional uplift in margin reflects ongoing efforts to effectively manage discounts to dealers and distributors and a minor benefit due to the product mix benefit of Focusrite Pro.

As a result, EBITDA grew by 11.4% and operating profit by 16.4%. The operating margin improved by 190bp, driving 22.6% growth in pre-tax profit to £7.2m. Consistent with the prior year, there were no exceptional items. Net cash has increased by £3.4m since the year end, to £26.2m.

Exhibit 1: Summary of results

£000s	H118	H218	FY18	H119	H1 growth y-o-y	H1 ccy growth y-o-y
Revenue by product type						
Focusrite	23,434	23,997	47,431	26,308	12.3%	
Focusrite Pro	2,259	2,503	4,762	2,594	14.8%	
Novation	11,419	8,647	20,066	9,827	-13.9%	
Distribution	1,707	1,155	2,862	1,696	-0.6%	
Total	**38,819**	**36,302**	**75,121**	**40,425**	**4.1%**	**0.5%**
Revenue by geography						
North America	16,852	15,868	32,720	14,963	-11.2%	-15.8%
Europe and Middle East	15,997	13,709	29,706	19,315	20.7%	18.4%
Rest of World	5,970	6,725	12,695	6,147	3.0%	-1.2%
Total	**38,819**	**36,302**	**75,121**	**40,425**	**4.1%**	**0.5%**
Gross profit	16,200	15,474	31,674	17,921	10.6%	
Gross margin (%)	41.7%	42.6%	42.2%	44.3%	6.2%	
Adjusted EBITDA	**7,969**	**7,516**	**15,485**	**8,881**	**11.4%**	
Adjusted EBITDA margin (%)	20.6%	20.7%	20.6%	22.0%	6.6%	
Operating profit	**6,230**	**5,383**	**11,613**	**7,251**	**16.4%**	
Operating margin (%)	16.0%	14.8%	15.5%	17.9%	11.8%	
Pre-tax profit	5,833	5,510	11,343	7,150	22.6%	
EPS (p)	8.9	8.7	17.6	11.0	23.6%	
Net cash	19,734	22,811	22,811	26,172	32.6%	

Source: Focusrite, Edison Investment Research

Revenue growth boosted by currency

Focusrite has a large international market, with c 85% of revenue generated outside the UK, and is therefore exposed to short-term currency fluctuations. In H1, the currency impact of euro-denominated sales (c 30% of revenue) was relatively muted, while sterling weakness against the US dollar (c 50% of revenue) benefited reported sales growth, as highlighted in the above table.

Divergence in regional sales performance

Sales growth in most countries in Europe, the Middle East and Africa (EMEA) was robust, with particularly strong demand for Focusrite products. Regional demand in Europe was further boosted by additional stock orders of c £0.5m by distributors in February amid Brexit uncertainty. This contributed to impressive EMEA sales growth of 20.7% (constant currency 18.4%) in H1.

Overall, North America regional sales declined by 11.2% (constant currency -15.8%). This is in marked contrast to both H118 and FY18 when constant currency sales grew by 34% and 17%, respectively, driven in part by strong demand for the Launchpad range. In this period, the

Launchpad range, which is now four years old, has declined. Also, the US market has been affected by the trade dispute with China. Focusrite dealt with this issue decisively by raising prices to protect the profitability of the group. Moving forward the management team is confident that its forthcoming new products will restore growth to this market.

Elsewhere, ROW sales increased by 3.0% (constant currency -1.2%). This was aided by growth in Asia of c 10%, despite the ongoing trade war between China and the US, offsetting challenging conditions in Latin America. The group is making the changes needed in this region to provide the foundation for growth in the future.

Product categories: Focusrite divisions powering ahead

By division, Focusrite and Focusrite Pro delivered robust revenue growth of 12.3% and 14.8%, respectively, while Novation declined by 13.9%:

Focusrite: Demand for the second-generation Scarlett range, which accounts for approximately three-quarters of divisional revenue and was launched in 2016, has continued to be robust and it remains the number one audio interface in the world. Scarlett delivered sales growth of c 12% and made further market share gains. The Focusrite Pro division, which includes the more expensive RedNet and Red ranges, was the fastest-growing segment with growth of 14.8%.

Novation: Having enjoyed several years of exceptional demand since launch in mid-2015, sales of the signature Launchpad model declined, leading to the Novation segment declining by 13.9% in H1. Consistent with the company's ongoing focus on product development and innovation, management has flagged a healthy pipeline of updated and new product launches over the next 18 months.

It also continues to strengthen its software products, including the app-based music creation tools (the Ampify brand), which support easy use of the Novation ranges and therefore make the products more accessible to novices. There are three app products that now have a combined total of more than 10.5m downloads, increasing at a rate of 120k downloads per month.

Balance sheet strength

Net cash increased by £3.4m to £26.2m compared with the year end (and by £6.5m y-o-y). This increase is a result of H1 EBITDA of £8.9m offsetting working capital outflows of £2.1m, capex of £2.3m, dividend payments of £1.3m and smaller items. Free cash flow as a percentage of revenue was 12%, compared with an average of 10% since the company listed in 2014.

The working capital outflow was mainly attributable to prompt payments to suppliers in H1 leading to a £2.3m reduction in payables, while a £0.9m increase in stock almost fully offset a £1.1m reduction in receivables. Stock levels in H2 are expected to increase further in advance of new product launches (two major launches have been flagged for the summer and autumn of 2019).

The company has employed a full-time business development officer and is actively assessing acquisition opportunities to invest surplus cash.

Forecast changes

We upgrade our PBT forecasts by 4.7% in FY19e and 5.2% in FY20e.

Exhibit 2: Changes to forecasts

£m	FY19e Old	FY19e New	% change	FY20e Old	FY20e New	% change
Revenues	78.0	78.3	0.4%	81.7	82.1	0.5%
Gross profit	33.3	33.8	1.6%	34.9	35.4	1.5%
Gross margin (%)	42.7%	43.2%	0.5%	42.7%	43.2%	0.4%
Adjusted EBITDA	15.9	16.1	1.0%	16.5	16.6	0.8%
Adjusted EBITDA margin (%)	20.4%	20.5%	0.1%	20.2%	20.3%	0.1%
Normalised operating profit	11.8	12.3	4.7%	12.0	12.6	5.2%
Normalised PBT	11.8	12.4	4.7%	12.0	12.7	5.2%
Normalised EPS (p)	17.9	18.8	5.1%	18.0	19.1	5.6%
Net cash	27.9	28.5	2.3%	33.8	35.2	4.0%

Source: Edison Investment Research

We leave our FY19e and FY20e revenue forecasts broadly unchanged, given trends seen in the US in H1, ongoing uncertainty regarding Brexit and the likelihood that the company will want to clear stock from the channels ahead of two major product launches, expected later this year.

We cautiously assume a further 50bp uplift to the gross margin in FY19e to 43.2%, below that achieved in H1 (44.3%). While this reflects the company's ongoing focus on managing margins and the positive mix effect of Focusrite Pro, a further increase in US tariffs to 25% is still a possibility. Should tariffs be raised, we would expect management to take actions to mitigate the margin impact over the medium term.

We have also adjusted our forecast tax rate down from 12% to 11%, consistent with H1 and prior years. While the majority of profits are taxed in the UK, the effective rate is lower than 19% due to enhanced tax relief on R&D.

We forecast net cash of £28.5m at the end of FY19, rising to £35.2m at the end of FY20.

Valuation: Market assumes cash utilisation

Focusrite is market leader in its specialist 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 DCF techniques to place a value on the longer-term income stream available to investors. As discussed below, we do not believe that this metric fully reflects the potential of the company's excess cash.

DCF: Long-term value reflected in sensitivity analysis

Over our 10-year horizon we assume revenue growth in years four to eight of 10%, fading to a terminal rate of 2%. We assume a terminal EBITDA margin of 21% (FY18: 20.6%), capex of c 7%, reducing to 5% by the terminal year, and an equity-only cost of capital of 8.4% (risk-free rate 3%, risk premium 6%, beta 0.9).

Based on these assumptions, which may prove conservative, our DCF values the shares at 471p (vs 457p before). In the table below we set out the share price implications for varying terminal sales growth rates and margin assumptions.

Exhibit 3: Sensitivity to terminal margin and sales growth rates (p/share)

		Sales growth FY21–27				
		8%	10%	12%	14%	16%
Terminal margin	**23.0%**	479	515	553	594	638
	22.0%	459	493	529	568	610
	21.0%	439	**471**	505	542	581
	20.0%	419	449	481	516	553
	19.0%	399	427	457	490	524

Source: Edison Investment Research

Share price assumes utilisation of cash at 12% return

While our DCF on the face of it does not point to value at or above the current share price, what we believe to be missing from the equation is the utilisation of Focusrite's net cash of £26.2m.

Focusrite generates high average taxed ROCE rates of 45–51%. It is not likely the company could generate such returns from an acquisition. However, using a range of lower ROCE rates, the cash would imply additional value as follows:

Exhibit 4: Potential returns on excess cash

ROCE	10%	15%	20%
Excess cash (£m)	26.2	26.2	26.2
Post-tax earnings (£m)	2.6	3.9	5.2
Incremental EPS (p)	4.5	6.7	9.0
Peer P/E (x)	15	15	15
Value per share (p)	67	101	134
Less cash per share (p)	(45)	(45)	(45)
Incremental valuation per share (p)	22	56	89
Implied share valuation (p)	**493**	**527**	**560**

Source: Edison Investment Research

The current share price would imply that the market is factoring utilisation of excess cash at a return on capital of c12%.

Exhibit 5: Financial summary

£000s	2016	2017	2018	2019e	2020e	2021e
Year end 31 August	IFRS	IFRS	IFRS	IFRS	IFRS	IFRS
INCOME STATEMENT						
Revenue	54,301	66,055	75,121	78,292	82,098	86,203
Cost of Sales	(33,439)	(39,704)	(43,447)	(44,498)	(46,661)	(48,994)
Gross Profit	20,862	26,351	31,674	33,794	35,437	37,209
EBITDA	10,249	13,109	15,485	16,067	16,646	17,291
Operating profit (before amort. and except).	7,677	9,470	11,613	12,347	12,596	12,845
Amortisation of acquired intangibles	0	0	0	0	0	0
Exceptionals	(537)	0	329	0	0	0
Share-based payments	0	0	0	0	0	0
Reported operating profit	7,140	9,470	11,942	12,347	12,596	12,845
Net Interest	(14)	42	(270)	20	60	70
Joint ventures & associates (post tax)	0	0	0	0	0	0
Exceptionals	0	0	0	0	0	0
Profit Before Tax (norm)	7,663	9,512	11,343	12,367	12,656	12,915
Profit Before Tax (reported)	7,126	9,512	11,672	12,367	12,656	12,915
Reported tax	(870)	(959)	(1,199)	(1,360)	(1,392)	(1,421)
Profit After Tax (norm)	6,793	8,553	10,144	11,006	11,264	11,494
Profit After Tax (reported)	6,256	8,553	10,473	11,006	11,264	11,494
Minority interests	0	0	0	0	0	0
Discontinued operations	0	0	0	0	0	0
Net income (normalised)	6,900	8,553	10,144	11,006	11,264	11,494
Net income (reported)	6,256	8,553	10,473	11,006	11,264	11,494
Average number of Shares Outstanding (m)	53.2	55.4	56.8	56.8	56.8	56.8
EPS – normalised diluted (p)	11.8	14.8	17.5	18.8	19.1	19.4
EPS - basic reported (p)	11.8	15.4	18.4	19.4	19.8	20.2
Dividend per share (p)	2.0	2.7	3.3	3.6	3.7	3.9
Revenue growth (%)	13.1	21.6	13.7	4.2	4.9	5.0
Gross Margin (%)	38.4	39.9	42.2	43.2	43.2	43.2
EBITDA Margin (%)	18.9	19.8	20.6	20.5	20.3	20.1
Normalised Operating Margin	14.1	14.3	15.5	15.8	15.3	14.9
BALANCE SHEET						
Fixed Assets	6,367	6,332	7,314	9,543	11,514	13,391
Intangible Assets	4,792	4,963	6,039	7,997	9,902	11,809
Tangible Assets	1,575	1,369	1,275	1,545	1,612	1,582
Investments & other	0	0	0	0	0	0
Current Assets	28,191	36,126	47,612	54,424	61,829	68,652
Stocks	11,361	9,000	11,391	12,923	13,040	13,960
Debtors	11,224	12,952	13,310	12,870	13,496	14,407
Cash & cash equivalents	5,606	14,174	22,811	28,530	35,190	40,179
Other	0	0	100	102	104	106
Current Liabilities	(9,256)	(8,663)	(11,136)	(11,091)	(11,362)	(10,842)
Creditors	(8,612)	(8,204)	(10,709)	(10,606)	(10,866)	(10,336)
Tax and social security	(644)	(459)	(427)	(484)	(496)	(506)
Short term borrowings	0	0	0	0	0	0
Other	0	0	0	0	0	0
Long Term Liabilities	(282)	(245)	(300)	(405)	(506)	(608)
Long term borrowings	0	0	0	0	0	0
Other long term liabilities	(282)	(245)	(300)	(405)	(506)	(608)
Net Assets	25,020	33,550	43,490	52,472	61,475	70,593
Minority interests	0	0	0	0	0	0
Shareholders' equity	25,020	33,550	43,490	52,472	61,475	70,593
CASH FLOW						
Op Cash Flow before WC and tax	10,249	13,109	15,485	16,067	16,646	17,291
Working capital	(6,009)	407	(427)	(1,194)	(483)	(2,362)
Exceptional & other	(417)	137	203	(0)	(0)	(0)
Tax	(165)	(633)	(478)	(1,360)	(1,392)	(1,421)
Net operating cash flow	3,658	13,020	14,783	13,512	14,771	13,508
Capex	(3,675)	(3,614)	(4,507)	(5,742)	(6,022)	(6,323)
Acquisitions/disposals	0	0	0	0	0	0
Net interest	(111)	(42)	(36)	20	60	70
Equity financing	172	258	306	0	0	0
Dividends	(976)	(1,138)	(1,679)	(2,071)	(2,150)	(2,266)
Other	365	84	(230)	0	0	0
Net Cash Flow	(567)	8,568	8,637	5,719	6,660	4,989
Opening net debt/(cash)	(6,173)	(5,606)	(14,174)	(22,811)	(28,530)	(35,190)
FX	0	0	0	0	0	0
Other non-cash movements	0	0	0	0	0	0
Closing net debt/(cash)	(5,606)	(14,174)	(22,811)	(28,530)	(35,190)	(40,179)

Source: Focusrite accounts, Edison Investment Research

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