MPC MARKETS

SMALL-CAPS

RECOMMENDATION

audinate

AD8:ASX

November 2024

GENERAL ADVICE ONLY - THIS RECOMMENDATION IS GENERAL ADVICE ONLY AND DOES NOT TAKE INTO ACCOUNT YOUR SPECIFIC CIRCUMSTANCES

AUDINATE GROUP LTD
AD8:ASX

MPC MARKETS

SMALL-CAPS RECOMMENDATION

AUDINATE AD8:ASX

Audinate Corporation (ASX: AD8) provides a solution that enables audio and video signals to be transmitted over standard ethernet cables. Fibre optics were not originally designed to transmit audio signals, and OEMs like Yamaha and Bose use Audinate's Dante protocol to ensure interoperability between their audio products. Audinate has parlayed this dominance in audio signal transmission to make inroads into the much more competitive market for video networking.

In theory, Audinate's competitive advantage arises from the number of technicians trained to implement Dante and the number of products that incorporate it. The reason customers buy Audinate hardware is the software installed on it, so it has always been a software company. But unlike most software companies, it makes most of its revenue from hardware sales, with just 25% of revenue coming from software sales in FY 2024.

Products

Dante is available in over 4100 products from more than 460 manufacturers, covering a diverse range of installations and applications across industries, including:

- Universities
- Conference Rooms
- Recording Studios
- Conference Centers

Growing network effect of Dante enabled products in market

4176

AUDINATE GROUP LTD
AD8:***ASX***

INVESTMENT CONSIDERATIONS

Leadership

CEO Aidan Williams co-founded Audinate, but the overall ownership by directors, and key management personnel, including Williams, is less than 4% of the company. This indicates limited alignment with shareholders.

All directors bought small amounts of shares at $13 during the 2023 capital raising, but four of them, including the CEO and Chairman David Krall, collectively sold over $4.6 million worth of shares when the price rose above $20 earlier this year. The CEO had also previously sold shares on the market at about $13.60 just a few weeks prior to the $13 capital raising.

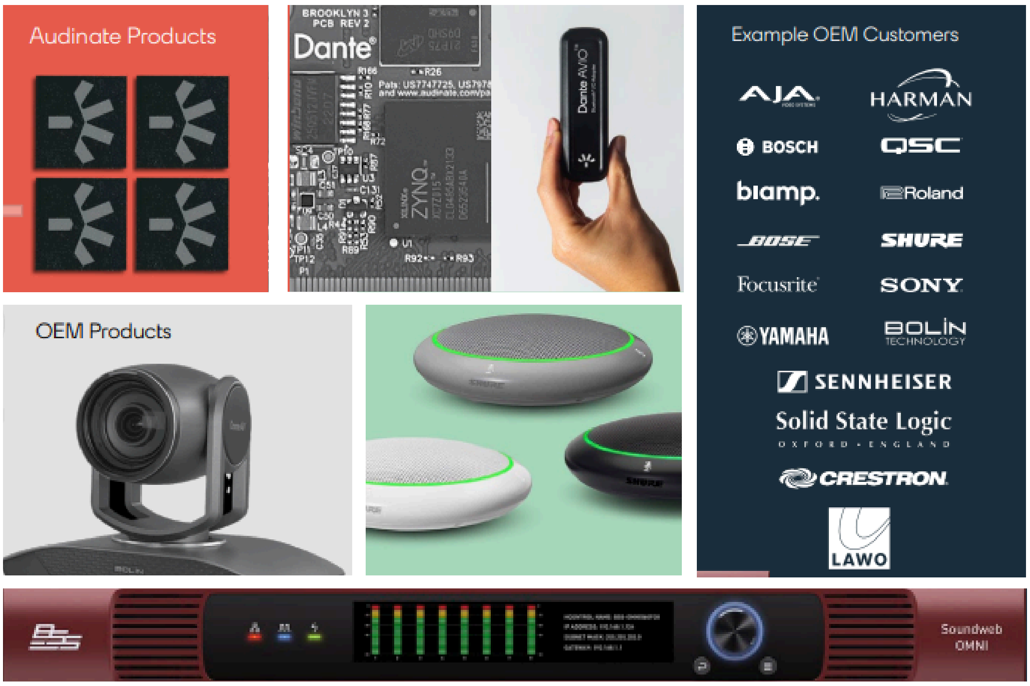
Subsequent to these share sales, in August 2024, the company informed the market that customers had a surplus of inventory and that profits would fall in FY 2025.At the AGM in October 2024, the company further downgraded guidance. Analysts are now expecting a significant decline in revenue and a loss of more than $10 million in FY 2025.

As a result, a pattern of insider selling in the future would arguably indicate that investors should take profits or exit the stock completely.

Financial Performance

Revenue	Gross Margin	NPBT	Revenue	Cash and Term Deposits	EBITDA
A$91.5m	74.3%	A$12.1m	US$60.0m	A$117.0m	US$20.4m
Up 31.3%	Up 3.1%	Up 10.7m	Up 28.4%	Up 77.0m	Up 85.5%

Product Range



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INVESTMENT CONSIDERATIONS

Valuation

In FY 2024, Audinate reported a net profit of $10.2 million, implying it trades on a PE ratio of about 76 at a share price of $9.30. However,Audinate will make a loss in FY 2025, so earnings multiples are of limited assistance in understanding valuation. On the bright side, funding this loss is not a near-term concern given that Audinate held cash and deposits worth over $118 million at June 2024.

It is difficult to estimate the true value of the business because we don't know what margins could be once it reduces investment in growth and gains a greater market share. However, it would be reasonable to expect strong margins at maturity given that the costs of switching away from its products only increase with its widespread usage.

Based on its enterprise value to trailing twelve months' revenue, the market is more pessimistic about Audinate than it usually has been in the past. However, this pessimism is at least partially justified by the fact that FY 2025 revenue could fall anywhere from 10% to 30% based on the latest outlook. Furthermore, the market cannot be sure when revenue will resume growth, though one can confidently predict it will eventually, once customer inventories have been adequately depleted.

Sociological Factors

Audinate is a peculiar company because it often gets conflated with higher-quality software businesses that earn more predictable recurring revenues. But because Audinate sells devices with software on them, rather than software as a service, its revenue is not recurring in nature.

In March 2024, Audinate was included in the S&P ASX 200 Index. Presumably, anticipation of this inclusion, subsequent to the 2023 capital raising, helped drive Audinate's share price run to over $20 (and over 20x trailing revenue). Since then, the share price has more than halved. This raises the very real possibility that Audinate could be removed from the Index in the near future, thus putting negative pressure on the share price.

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RISKS

Risks

Audinate is a "fallen-angel" stock that is about to put an end to a solid run of strong organic revenue growth. Its business momentumis now negative, and its share price momentum is also negative. Until results improve, the share price is unlikely to gain much. And if results continue to disappoint, the share price could go lower. There is, therefore, a case to be made that investors should wait for improved results before buying.

Ultimately, any thesis for investing in Audinate assumesmanagement will be able to turn around the business after a disappointing FY 2025, so there is a substantial execution risk. Audinate needs destocking to finish and demand to grow beforethe share pricewill respond. But demand is not something Audinate can control from period to period. If, for whatever reason, sales don't improve in FY 2026, the investment thesis will have failed.

WHY HOLD THE COMPANY?

Why hold the Company?

In the past, Audinate has proven that it has pricing power, and can make a profit. After a very tumultuous twelve months,the Audinate shareholders who failed to sell some shares when the directors did are left shaken by their experience.
However, once Audinate returnsto growth, negativity about the businessshould recede.
The CEO's remuneration depends in part on total shareholder returns from now to the end of August 2027. The larger part of his long-term incentive is based on gross profit growth to the end of June 2027. If these incentives work as intended,sentiment around Audinatestock should be a lot more positive in August 2027 than it is today.

Audinate is appropriate for investors who are willing to invest in a volatile stock for at least 3 years because it is a "sin-binned" stock that has disappointed investors recently. In 3 years, the company should have returned to growth, and the narrative around the business should have become more positive. Ideally, investors would benefit from both revenue growth and multiple expansion.

Conclusion

Audinate faces a complex investment scenario with recent challenges and potential long-term opportunities. The company expects over $10 million in losses for FY 2025 due to customer inventory surpluses and downgraded financial guidance. Despite a $10.2 million net profit in FY 2024, the stock's high PE ratio of 76 and insider selling raise concerns.
The market is uncertain about revenue growth resumption, as Audinate lacks recurring revenue typical of software companies. However, the company's strong cash position and historical pricing power suggest potential upside if management navigates the downturn and restores growth by FY 2026. Brokers may advise caution until clearer recovery signs emerge, while acknowledging potential for significant rebound if operational challenges are managed successfully.

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Our Commitment

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