

Audinate Group Investment Case

#ad8 \$8.80 #2024/08/10

#microcapclub

Ticker: AD8.AX

Price: AUD\$8.80

Shares Outstanding: 83.1 million

Market Cap: AUD\$735.4m (US\$485m)

Enterprise Value: AUD\$623.9 (US\$412m)

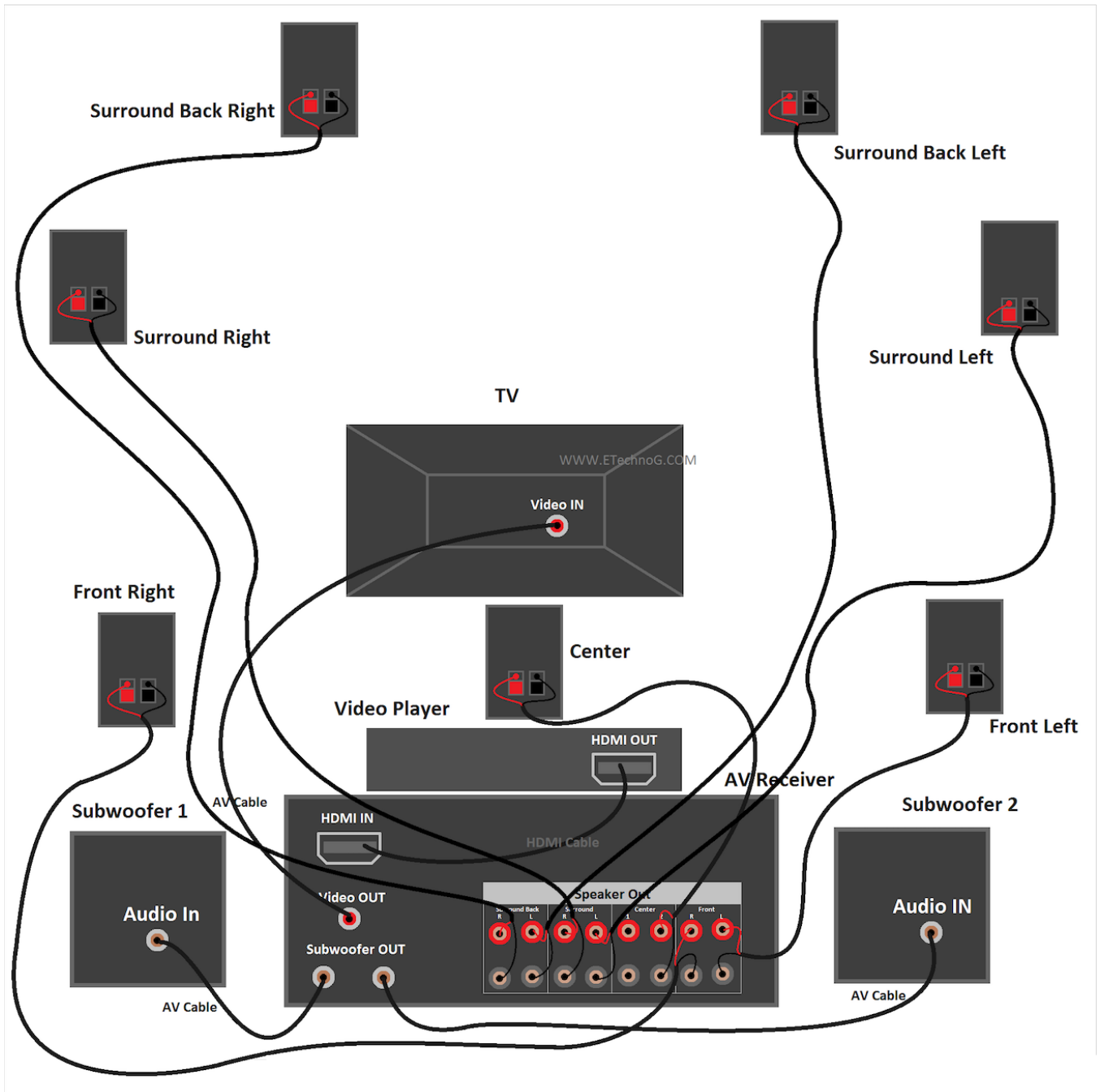
All monetary figures unless otherwise specified are in AUD

Summary

Audinate is a high-quality business that holds a globally dominant position in professional audio networking. However, the company primarily operates as a supplier of components to audio equipment manufacturers, which can lead to volatile revenues during supply chain disruptions. A recent downgrade in FY25 guidance has resulted in a sharp decline in share price, relegating Audinate once again to micro-cap status. For investors willing to look past short-term uncertainties and focus on long-term trends and opportunities, this may present an excellent chance to own a truly unique, globally dominant business.

Audio Networking

If you've set up a home theatre system, you're likely familiar with the process of connecting audio components. Typically, an AV receiver acts as the central hub, with audio cables running from it to various speakers throughout the room.



Audio equipment connected with analogue cabling

The same principle applies to professional settings such as stadiums, theatres, concert venues, universities, public transit networks, houses of worship, corporate offices, and broadcast facilities. The key difference lies in the scale: these environments require significantly more of everything. This includes a greater number of speakers and amplifiers, as well as additional equipment like microphones, mixers, and other commercial and professional-grade audio devices.

Analog audio installations, particularly in larger and more complex venues, present several significant challenges:

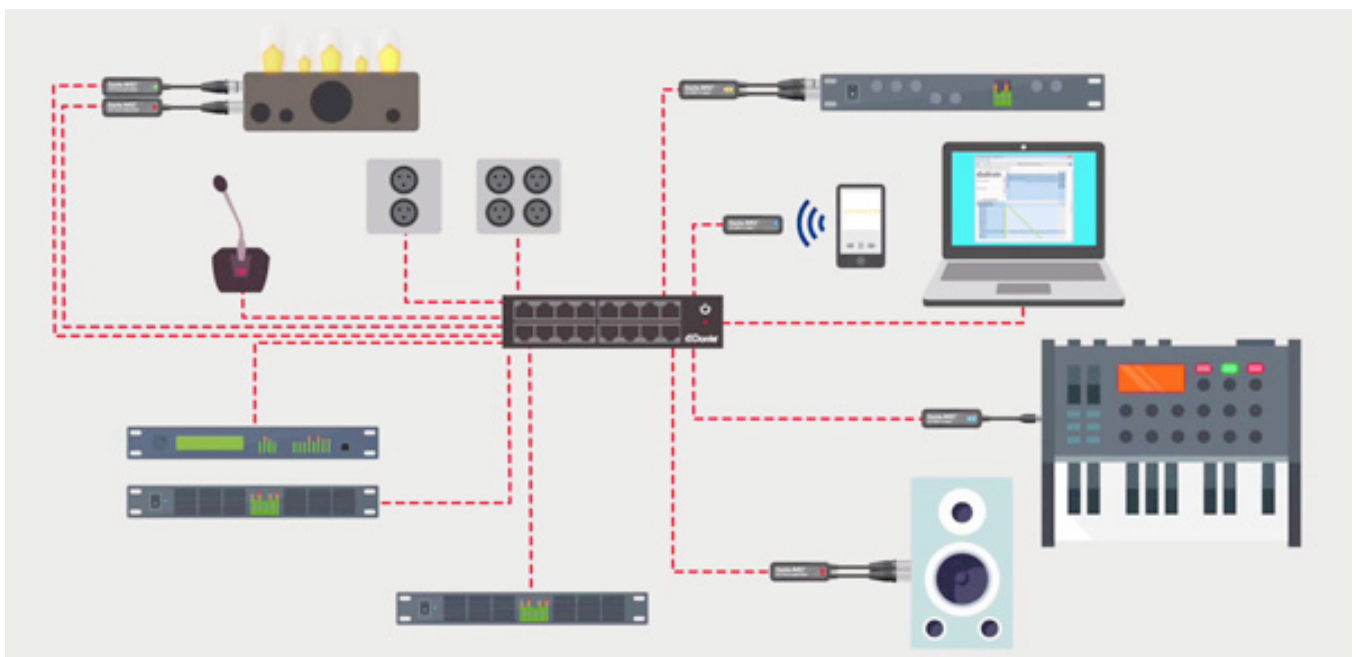
1. Inflexibility: Installing new equipment or re-routing audio often requires physically plugging and

unplugging cables. This can necessitate the costly and time-consuming process of running new cabling to different parts of the venue.

2. Complexity: These setups require bulky cabling throughout the venue for every point-to-point connection. This can quickly become unmanageable, demanding meticulous discipline in labelling and cable management to maintain order.
3. Troubleshooting difficulties: During live events such as concerts or university lectures, isolating and resolving issues like a faulty speaker or cable producing crackling noises can be extremely challenging. This not only disrupts the event but also creates significant stress for the participants involved.

Audio networking emerged in the mid-1990s as a solution to many of the issues inherent in analog systems. Instead of relying on point-to-point connections, audio networking connects all devices via standard ethernet cabling. This approach addresses several key problems:

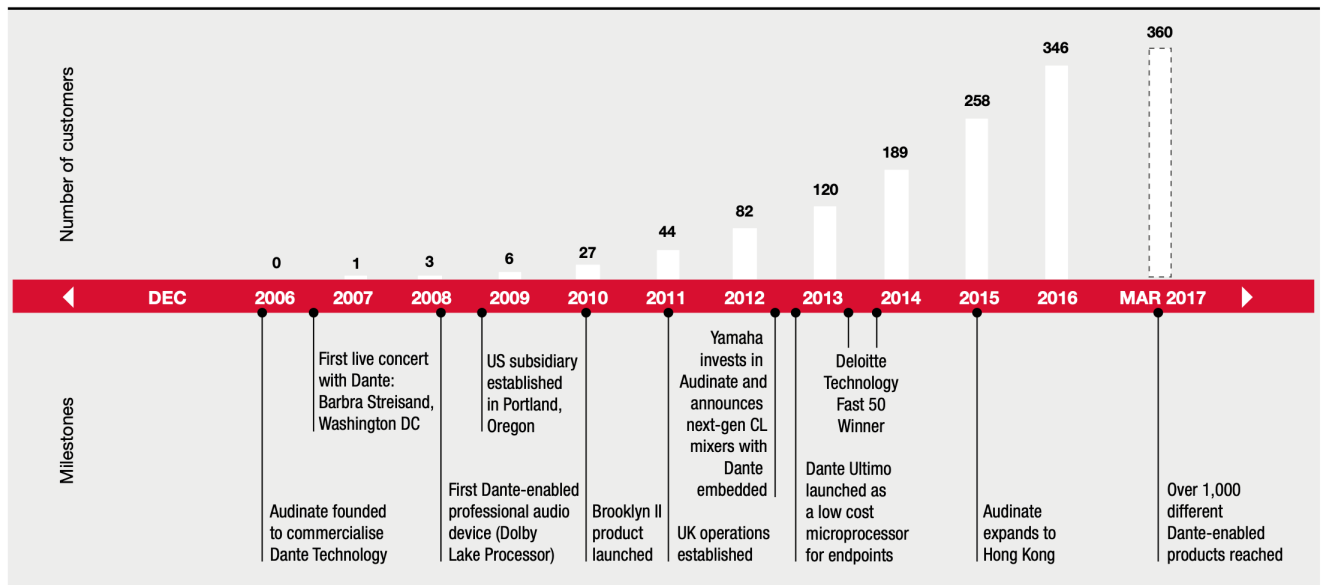
1. Flexibility: Audio routing can be accomplished with a simple switch flip or mouse click, even for audio sources in different rooms, over long distances, or via the internet. Adding new devices is as straightforward as connecting them to the venue's existing ethernet network.
2. Simplicity: All devices, including AV receivers and amplifiers, require only one Ethernet cable (or two for redundancy if needed), eliminating the "cable spaghetti" problem. Moreover, these are standard ethernet cables, unlike analog cables that vary in gauge, materials, and terminations.
3. Enhanced Troubleshooting: Modern audio network equipment can be managed, diagnosed, and troubleshot from a central location or even remotely. This allows audio engineers to perform preemptive maintenance when diagnostics indicate potential issues, reducing the risk of live event disruptions.



History

Audinate emerged from the National ICT Australia (NICTA), a government-funded research lab, in 2006. Shortly thereafter, the company introduced its audio networking protocol, Dante (Digital Audio Network Through Ethernet).

FIGURE 19: AUDINATE TIMELINE AND CUSTOMERS



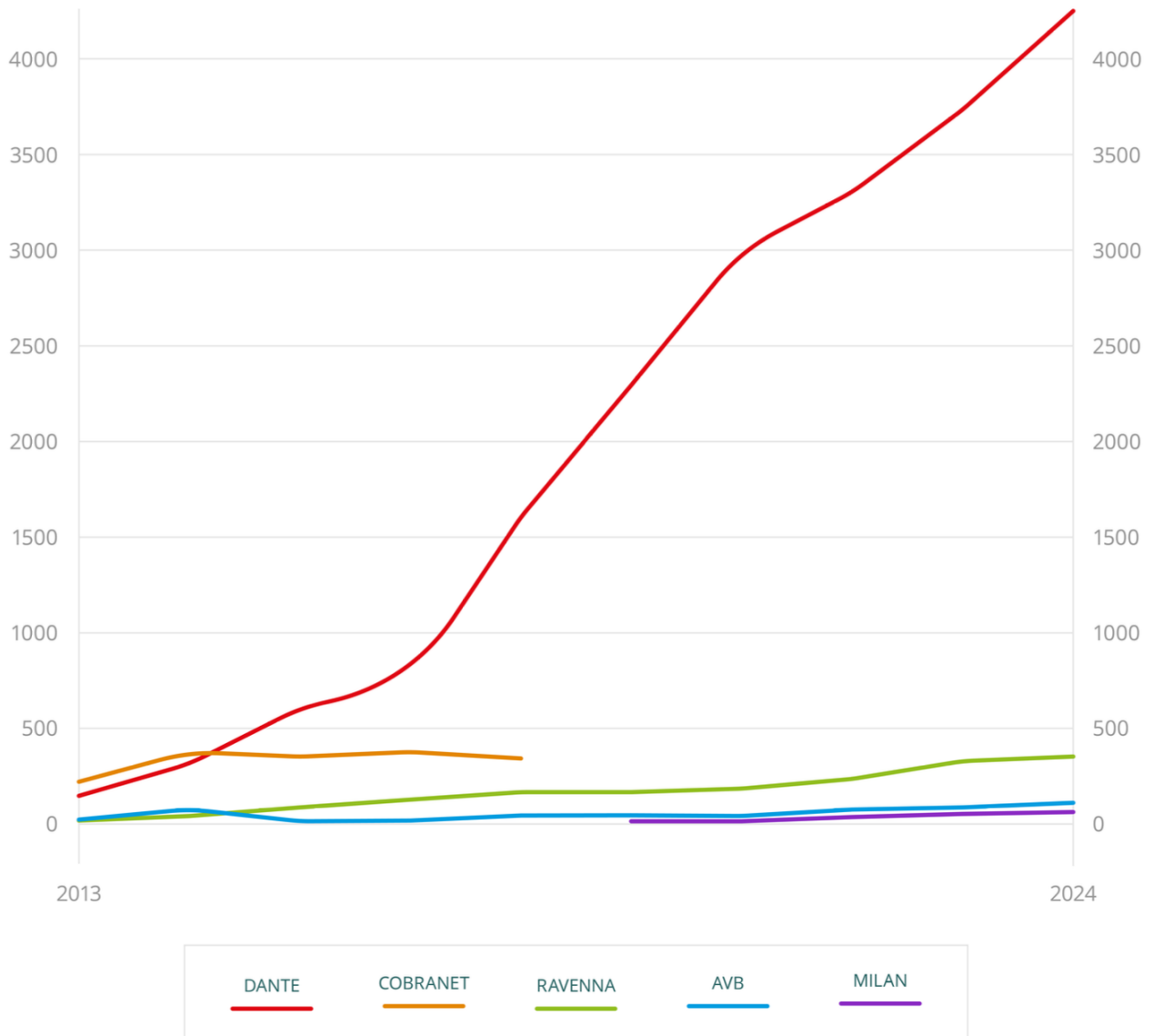
Dante began gaining significant traction in 2009 when Yamaha, a major player in the audio industry, started adopting the protocol for its products. This relationship was further cemented in 2012 when Yamaha made a strategic investment in Audinate, acquiring an ownership stake (approximately 8% today).

Following this pivotal partnership, Dante quickly surpassed the existing audio networking leaders of the time, notably Corbanet and Ethersound. By 2015, Audinate had established itself as the market leader in audio networking technology.

In 2017 the company went public on the Australian Stock Exchange (ASX). Audinate's initial public offering (IPO) was priced at AUD\$1.22 per share, valuing the company at a market capitalisation of AUD\$72.6 million. At the time of the IPO, Audinate reported annual revenues of AUD\$14.6 million.

Audinate has continued to solidify its market leadership position. Dante has become the de facto standard for professional audio networking, as evidenced by the following chart:

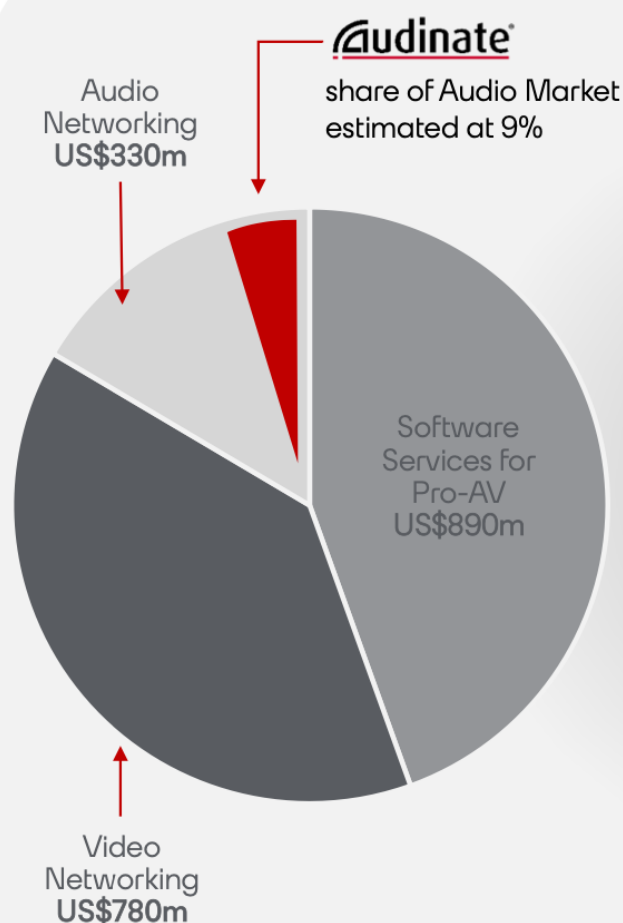
TOTAL AUDIO PRODUCTS PER PROTOCOL



Source: *Networked Audio Products 2024*

Despite this success, there remains significant room for growth. Analog audio cabling still dominates in professional settings, and Audinate's management estimates that they have only penetrated 9% of their addressable market in professional audio to date. This suggests substantial opportunities for future expansion.

Audinate Updated TAM* US\$2bn*



Additional revenue opportunity to fulfill Dante software vision is *incremental* to the TAM and not depicted in the TAM pie chart

Updated TAM calculation published October 2023

Source: Audinate, Feb 2024

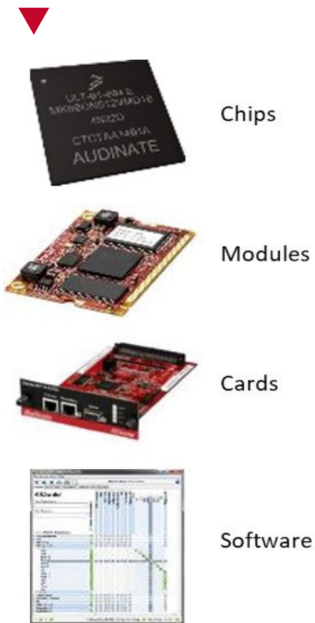
Audinate's financial performance reflects this growth potential. The company is projected to achieve revenues of \$91.5 million in FY24, representing a compound annual growth rate (CAGR) of 30% since FY17. This impressive growth trajectory underscores the increasing adoption of Dante technology in the professional audio industry.

Dante

Dante is an audio networking protocol that enables interoperability between professional audio equipment from different manufacturers over standard ethernet networks. Many leading brands, including Yamaha, Bose, Shure, and Sennheiser, have adopted this technology.

Dante allows diverse equipment (e.g., a Yamaha mixer, Shure microphone, and Bose speaker) to work seamlessly together. Audinate provides software and APIs for the management, patching, routing, security, and diagnostics of all Dante enabled AV equipment.

Audinate products



OEM example customers

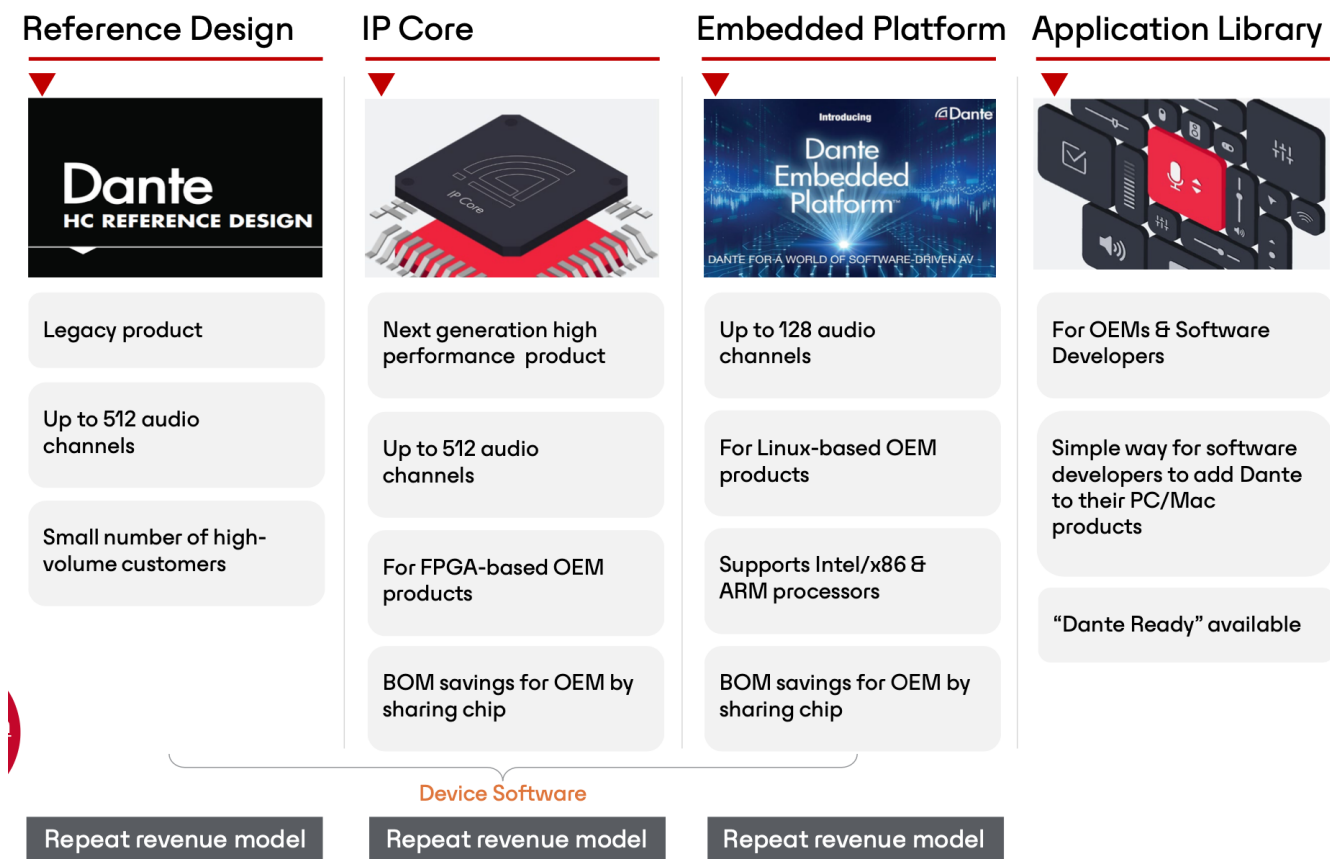


OEM products



Chips, cards, modules and software

Dante is currently primarily expressed in the form of chips, cards and modules (CCMs). Original Equipment Manufacturers (OEMs) incorporate these CCMs into their professional audio equipment, allowing them to market their products as Dante-compatible. This model yields Audinate an impressive ~70% gross margin.



Reference designs, software for chips, operating systems and applications

Recently, a growing number of OEMs have been shifting from Dante CCMs to using their own provisioned chips using Audinate's software and designs. This transition, accelerated by post-pandemic supply chain issues, results in nearly 100% gross margins for Audinate. While the net profit per unit remains similar, this software-centric approach offers greater flexibility, reduced cost and resilience against hardware supply constraints.

At its core, Dante is not chips, cards and modules or even software - it's an ecosystem . An ecosystem that AV equipment companies can join to make their products more appealing to professional AV customers.

Dante's ecosystem approach is reminiscent of Dolby's model, which enhances value across the audio-visual chain. Just as Dolby technology benefits AV manufacturers in selling TVs and audio equipment, while also enabling movie studios and streaming services to deliver superior content.

I liken Dante most to the Apple Home and Google Home ecosystems in consumer home automation. Folks over in the [Shelly Group](#) thread would know the value of these ecosystems well. One can buy a smart door bell, or some smart lights and use the vendor specific software to control them. But consumers really want all their smart devices from different equipment manufacturers to work and can

be managed together.

The true value of Dante lies in its ability to integrate and manage various AV devices from different manufacturers seamlessly - a critical need in professional audio settings.

This ecosystem exhibits strong network effects: as more OEMs adopt Dante, the ecosystem's value grows, attracting more customers. Unlike consumer home automation market, Dante stands alone in professional audio networking, making it a unique "one-of-one" business.

Great Expectations

	FY18	FY19	FY20	FY21	FY22	FY23	FY24
	A	A	A	A	A	A	E
Chips, cards, modules - units		24,031	23,517	23,798	33,569	51,292	
Chips, cards, modules - subs and maintenance					267	425	
Software - units		3,779	6,123	9,167	10,767	15,052	
Software - subs and maintenance					1,230	2,185	
Other		503	677	404	459	745	
Total Revenue	19,653	28,313	30,317	33,369	46,292	69,699	91,500
Cost of goods sold	(5,011)	(7,250)	(7,109)	(7,865)	(11,701)	(19,471)	
Gross Profit	14,642	21,063	23,208	25,504	34,591	50,228	67,985
Employee expenses	(9,073)	(12,288)	(15,797)	(17,811)	(23,890)	(29,456)	
Sales and Marketing expenses	(2,338)	(2,631)	(2,484)	(1,688)	(2,614)	(4,385)	
Admin and other operating	(2,672)	(3,379)	(2,895)	(2,956)	(3,791)	(5,375)	
D&A	(1,452)	(2,419)	(4,422)	(6,534)	(8,658)	(10,576)	
IPO expenses	0	0	0	0	0	0	
Other non-operational	0	0	0	0	0	0	
Foreign exchange	0	0	11	(590)	(34)	67	
EBIT	(893)	346	(2,379)	(4,075)	(4,396)	503	7,990
Finance costs	0	0	(117)	(105)	(173)	(239)	
Other income	157	296	823	1,094	185	1,129	
PBT	(736)	642	(1,673)	(3,086)	(4,384)	1,393	
Income Tax benefit/(cost)	3,280	20	(2,465)	(355)	(73)	9,250	
NPAT	2,544	662	(4,138)	(3,441)	(4,457)	10,643	
PBT Normalised	(2,313)	(2,721)	(4,643)	(4,030)	(6,886)	(2,194)	
EBITDA	559	2,765	2,032	3,049	4,296	11,012	20,000

Audinate's financials tell a compelling story:

- 20-30% annual revenue growth
- Emerging operating leverage and profitability
- Organic growth, with one small acquisition in video networking

It seems like smooth sailing for an upcoming darling of the ASX. However in this span of time, it was had two major crises of confidence. Once during and following the global pandemic of 2020-2022, and another just in the last week.

Market Summary > Audinate Group Ltd

8.38 AUD

+ Follow

+6.85 (447.71%) ↑ all time

7 Aug, 1:35 pm AEST • Disclaimer



The initial share price fall during the start of the pandemic is not hard to explain. All of Audinate's target markets - universities, stadiums, concerts, offices, etc were shutting their doors and going remote. There was fear and panic on how long this would last and if or when professional AV companies will return to normal levels of purchasing. As the fear and uncertainty subsided, the share price rebounded and returned to all time highs. However subsequent supply chain issues dogged the company, which once again saw its share price beach under \$6 in May 2022.

During the beginning of the pandemic in March 2020, global manufacturing across the board - auto, electronics, home appliances, chips, audio visual equipment - slowed or even halted in the face of an uncertain demand environment. But the world didn't end, and in fact demand of electronics surged and the factories were once again ramped up to maximum.

There were a lot of logistical and supply issues at the time. One of the most heavily impacted areas was trailing edge chips. For leading edge chips - for example the latest products from Nvidia, Apple Silicon, AMD, Intel and Qualcomm - supply can be increased by building new fabrication plants. However trailing edge chips were made in old, previously cutting edge, fabrication plants. It's much harder to increase the supply as foundries loathed to invest in additional supply for older, lower margin products. Audio processing chips don't have high performance requirements, and along with chips used in automobiles and home appliances were predominately trailing edge chips.

In order to secure chip supply, Audinate was forced to redesign a number of products to use newer chips. Audinate's OEM customers were likewise forced into product redesigns - accounting for Audinate's redesigns as well as other electronic supply constraints they contended with. All in all, there was a lot of product and sales delays. By mid-2023, this was all cleared up and Audinate was once again supplying its full product offering. Despite a slowing of sales in FY20 and FY21, nothing more appeared to have come of it. The following years of FY22, FY23 and FY24e saw top line revenue surge by 39%, 51% and 31% respectively with the company inflecting hard into profitability.

Whiplash

On August 6, 2024, Audinate's market update delivered a shock. While FY24 results were solid and in line with expectations, the FY25 guidance reset expectations dramatically, projecting a revenue decline and lower gross profit.

A few factors that drove revenue in FY24 are now not expected to continue in FY25:

- Pent up demand for chip that had been severely supply constrained
- Over-ordering by OEM customers to ensure component availability for their products.
- The continued normalisation of inventory levels by customers.
- Promotional sales and the discontinuation of a video product from its previous video networking acquisition.

These factors combined are expected to create a revenue headwind of US\$12.8m (AUD\$19.7m).

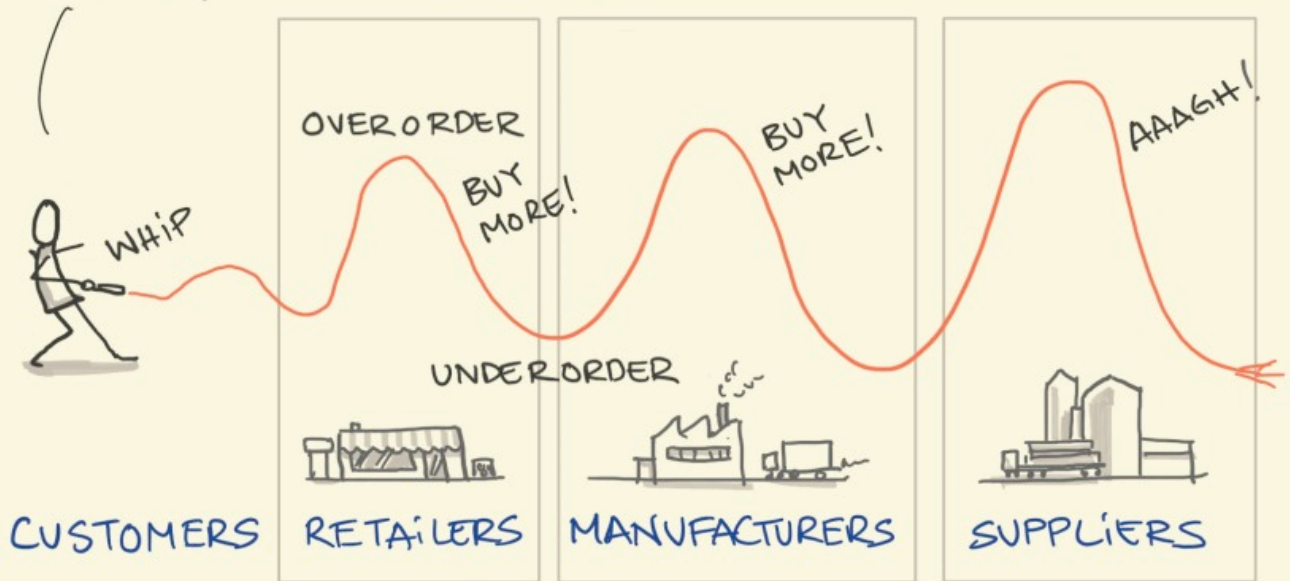
THE BULLWHIP EFFECT

SMALL CHANGES
IN DEMAND

CAN PRODUCE
→

A WHIP-LIKE
EFFECT UPSTREAM

QUICK! BUY TOILET PAPER



sketchplanations

The Bullwhip Effect

This situation is a classic example of the Bullwhip Effect in action, with FY24 likely representing the peak of demand pull-forward. It serves as a brutal reminder that Audinate remains vulnerable to supply chain fluctuations.

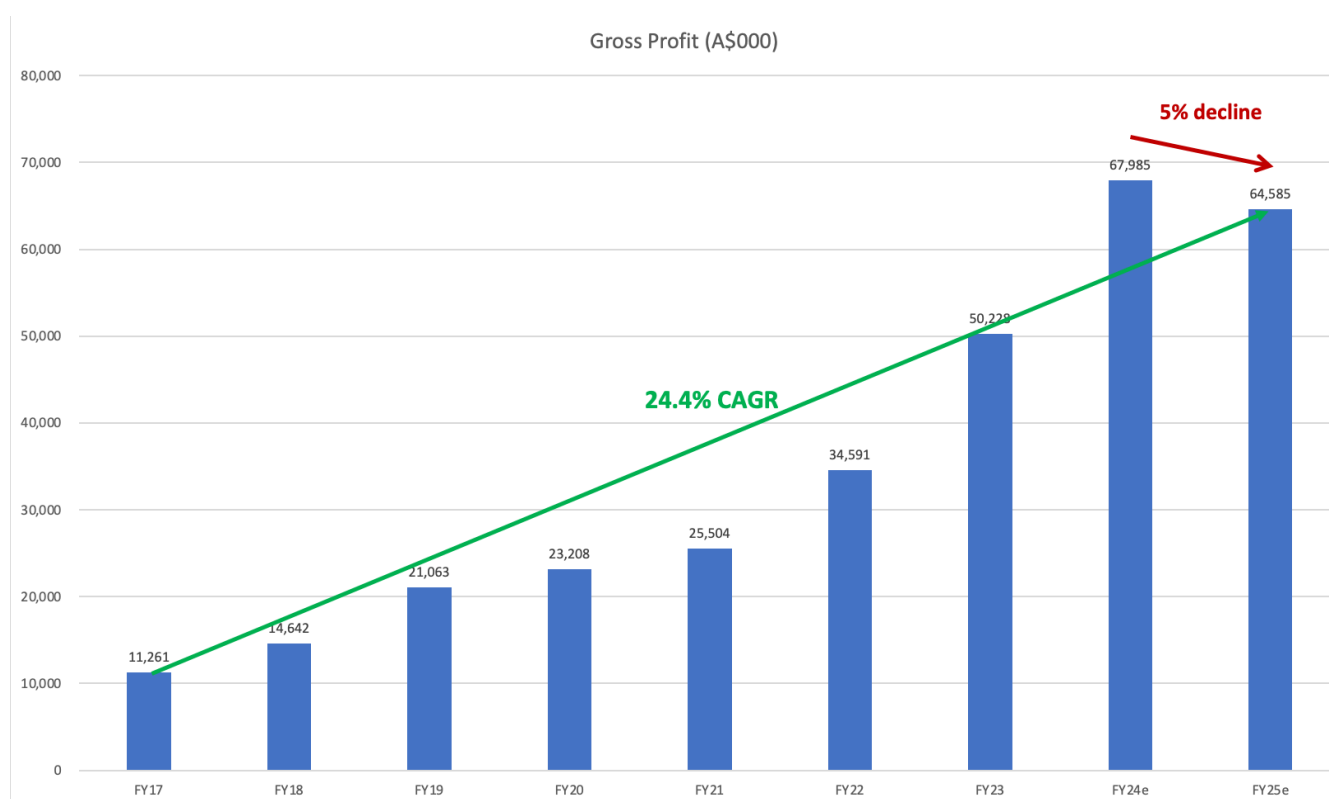
Amplifying this issue is Audinate's position in the supply chain. As a component supplier to professional AV equipment manufacturers, who in turn sell to distributors and installers, the company is several steps removed from end customers. This distance can obscure true end-customer demand, as inventory decisions along the chain create waves that mask underlying performance.

The market's reaction was swift and severe. When a growth company valued at growth-y prices suddenly expects no growth, the market reacts accordingly. On August 6, 2024, Audinate's share price plummeted by 35% in a single day, underscoring the market's sensitivity to shifts in growth expectations for high-valuation companies.

The AUD\$700m question

For investors willing to look past the short-term turbulence, Audinate presents a rare opportunity. It's a chance to invest in a global leader with a monopolistic position, substantial growth potential, and network-effect economics - all at a potentially reasonable price.

Assuming FY25 represents normal demand conditions (a conservative stance), Audinate's gross profit would have compounded at a 20.5% CAGR over the six years from pre-pandemic to FY25. This growth rate could be even higher if FY25 turns out to be a trough rather than a new baseline.



I'm using Gross Profit to normalise the trend of customers transitioning from lower margin chips, cards, and modules to higher margin software revenue

The company's growth potential remains significant. Many potential customers are still using analog cabling and grappling with its management overheads. Given Audinate's dominant market position, it's conceivable that the company could maintain this growth rate for at least another five years.

Valuation perspective: Assuming a 20% annual growth rate for the next five years, a P/E of 40, and a net margin of 20%, discounted to present value, I estimate Audinate's fair value at around \$12 per share.

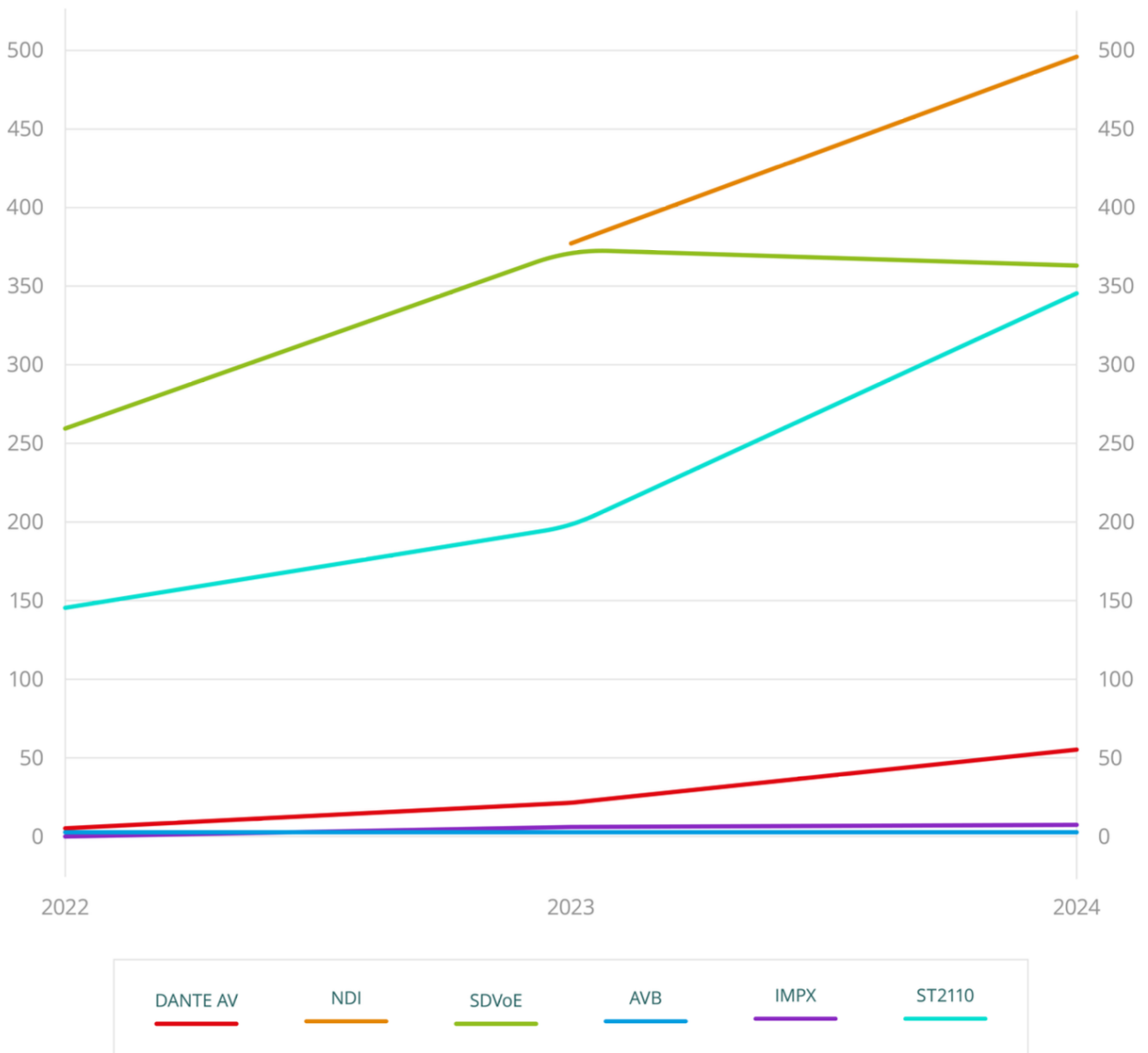
Risks

- **Demand Uncertainty:** The recent guidance reset for FY25 raises questions about the nature of the demand decline. Is it merely a result of the Bullwhip Effect, or does it signal a more structural shift in the market? The upcoming FY24 results release and conference call should provide crucial insights into the factors behind this significant reset in expectations.
- **Leadership Transition:** The recent resignation of the CFO, while attributed to career aspirations, introduces an element of uncertainty. Although it appears to be a natural career progression, the possibility of underlying issues cannot be entirely dismissed. The smooth transition to a new CFO and their subsequent performance will be critical to watch.
- **R&D Focus:** A significant portion of R&D expenses is going into the pursuit of opportunities outside of their audio networking core competency (more on this later). This would potentially end up being a cash sink with very little payback.
- **Hardware to Software transition:** The current trend sees audio equipment manufacturers moving away from sourcing chips from Audinate, but rather procuring their own chips and licensing Audinate's software. Although there has been no evidence of this yet, it might decrease the barriers for new entrants.

Video complements the Audio Star

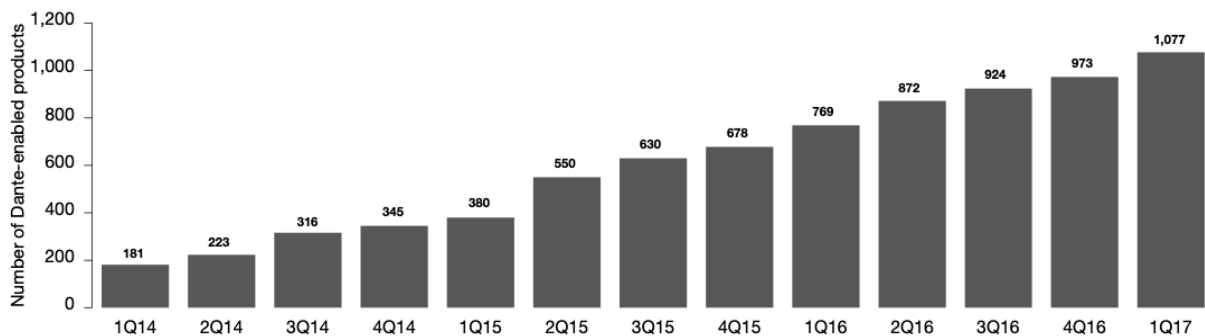
Audinate is aiming to replicate its audio networking success in the video domain with Dante AV. The video networking market faces similar challenges to audio: a multitude of cable types (HDMI, SDI, DisplayPort, VGA) creating complex, point-to-point connections. Video networking promises to simplify this by using standard Ethernet networks, offering flexibility, ease of maintenance, and improved diagnostics.

TOTAL VIDEO PRODUCTS PER PROTOCOL



Source: RH Consulting: Networked Audio Products 2024, Feb 2024

FIGURE 24: TOTAL DANTE-ENABLED PRODUCTS AVAILABLE



Source: Audinate IPO Prospectus, June 2017

The video networking market appears to be where audio networking was in 2015, approximately nine years behind. Currently, it's primarily a two-horse race between NDI, launched in 2015, and Dante AV, introduced in 2020.

ST2110 and SDVoE, despite having more video products than Dante AV, don't appear to be likely competitors. ST2110 is suite of video standards, and while used in high-end live broadcast environments - it's not a plug and play video ecosystem. SDVoE is a protocol driven by semiconductor manufacturer Semtech (NASDAQ: SMTC), and appears from the outside to be unfocused, scattered with declining market share.

NewTek's NDI was first introduced in 2015, and has a 5 year head start on Dante AV. Its strengths line in live broadcast, streaming, content creation and remote production environments where its free software development kits allow for deep integration with various video production tools. NewTek was purchased by Vizrt Group in 2019, which itself is owned by a large Scandinavian private equity fund.

Audinate's entry into video networking was launched in 2020 in the form of Dante AV. In late 2021 it made the acquisition of Silex Insight for up to US\$8m - it's only business acquisition - to help bolster its video codec and video integrated circuit experience. Dante AV's target market is the same as its Dante Audio products - physical spaces, stadiums, churches, universities, offices. While still at the very early stages of adoption, Dante AV has already gathered significant traction with a list of 50 OEM licensees and 66 Dante Video products launched.

By far Audinate's biggest advantage in video is the ability to leverage their dominant position in audio. Dante AV is managed, administrated, and controlled in exactly the same way and is fully integrated with Dante Audio. Existing Dante Audio end-users can add Dante AV cameras and receivers onto their ethernet network and have a seamless audio visual experience without the need for **complicated splitters and converters**.

The video networking market is estimated by management to be twice the size of audio networking. The opportunity is huge. Should Audinate gain traction and eventual dominance in this market, which is a decent probability given its competitive position in audio, its current growth rates will likely extend out by a further decade.

Final Say

The recent reset of FY25 revenue expectations has triggered a sharp decline in Audinate's share price. With an EV/Sales ratio of 6.8x and a likely fall back to break-even in FY25, the company may not immediately appeal to value investors. However, Audinate's unique position in the market warrants closer examination.

Audinate stands as a true "one-of-one" business, holding a dominant position in audio networking. The company still has significant room for growth within its core market, and its business model benefits from attractive network economics.

If the recent downturn proves to be merely a temporary effect of an unprecedented supply chain Bullwhip Effect, the current market reaction may present a rare opportunity for investors who can look beyond short-term fluctuations. Audinate's established success in audio networking positions it well to expand into video networking - a move that could be transformative for the company's long-term prospects.