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Redbubble

Setting the pace

ADD (no change)

Current price:	A$1.50
Target price: ▲	A$1.76
Previous target:	A$1.38
Up/downside:	17.1%
Reuters:	RBL.AX
Bloomberg:	RBL AU
Market cap:	US$252.8m
	A$312.7m
Average daily turnover:	US$0.27m
	A$0.35m
Current shares o/s	198.4m
Free float:	70.0%

Key changes in this note

FY18F EPS up by 2%.

FY19F EPS up by 224%.

FY20F EPS up by 10%.

Source: Bloomberg

Price performance	1M	3M	12M
Absolute (%)	11.1	89.9	69.5
Relative (%)	11.4	87.5	62.8

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- RBL produced a strong first half where all key metrics – traffic, GTV and revenues – were comfortably ahead of our forecasts.
- Gross profit after paid customer acquisition costs remains under pressure but the company remains confident margins will lift in H2.
- Our DCF valuation has increased to A$1.81 per share (from A$1.52). Our price target - derived from the DCF method and EV/sales and EV/GP multiple-based methods - has increased to A$1.76 (from A$1.38).
- The company reiterated guidance for full year revenue growth greater than 30% and for regular positive monthly EBITDA by year end.
- We maintain an ADD recommendation (High Risk).

Growth rates exceed our forecasts

Redbubble produced a strong first half for FY18 as the company continued to outpace competitors. Customer visits, gross transaction value (GTV) and revenues were all comfortably ahead of our forecasts. Costs were well under control and the cash balance was $2m better than expected. Promotional and discounting activity resulted in a weaker gross profit margin for the December quarter, but the company says GP margin will recover in the second half as new fulfiller discounts kick in. We are pleased with the overall quality of the result.

Upgrade to valuation and price target

Our profit forecasts have increased. Our DCF valuation has increased to A$1.81 per share, up from A$1.52 per share, helped by a reduction in our WACC assumption to 13.2% (from 14.4%), due to the decreasing operational and financial risk. Our price target – derived from a blend of DCF valuation and multiple-based methods – has increased to A$1.76 per share (up from A$1.39/share).

Risks and catalysts

Risks to RBL include: 1) failure to grow GTV and revenue at the expected rate; 2) Slower roll-out of performance improvement initiatives; 3) deterioration of foreign exchange rates; 4) Further increases in mobile customer acquisition costs and; 5) irrational competitor behavior. Potential near term catalysts include: 1) better GTV and gross margin growth rates; 2) a strong consumer response to the current growth initiatives, especially mobile user experience and; 3) competitors falling behind in terms of product range and user experience.

Investment view

RBL operates a fast-growing global marketplace in art-inspired consumer goods. In our view the global market potential for its merchandise is highly attractive. The company has yet to reach cash-flow break even and is thus High Risk. However successful implementation of the current strategy would deliver substantial returns commensurate with this risk. As the stock trades below our revised valuation and price target, we maintain an ADD recommendation.

Financial Summary	Jun-16A	Jun-17A	Jun-18F	Jun-19F	Jun-20F
Revenue (A$m)	114.6	141.0	184.6	247.7	322.3
Operating EBITDA (A$m)	-8.97	-8.27	-2.07	10.93	23.43
Net Profit (A$m)	-20.10	-7.56	-8.29	4.11	15.54
Normalised EPS (A$)	-0.11	-0.07	-0.04	0.02	0.07
Normalised EPS Growth	147%	(34%)	(43%)		278%
FD Normalised P/E (x)	NA	NA	NA	76.11	20.12
DPS (A$)	-	-	-	-	-
Dividend Yield	0%	0%	0%	0%	0%
EV/EBITDA (x)	NA	NA	NA	19.88	7.04
P/FCFE (x)	NA	NA	NA	43.78	16.63
Net Gearing	(107%)	(83%)	(98%)	(102%)	(104%)
P/BV (x)	6.54	9.29	4.99	3.35	2.20
ROE	(80.9%)	(36.0%)	(17.2%)	5.3%	13.2%
% Change In Normalised EPS Estimates			2%	224%	10%
Normalised EPS/consensus EPS (x)			1.37	3.94	1.66

SOURCE: MORGANS, COMPANY REPORTS

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Figure 1: Financial summary

ASX Code	RBL	Share Price	A$	1.50
Issued shares (m)	208.4	Recommendation:		ADD
Market Capital (A$m)	313	Blended Valuation:		1.76
		Price Target:		1.76
		TSR:		17.1%

Key Financials		2016	2017	2018E	2019F	2020F
Reported NPAT	A$m	-20	-8	-8	4	16
Normalised NPAT	A$m	-18	-14	-8	4	16
EPS - reported	¢	-11.7	-3.7	-4.0	2.0	7.5
EPS - normalised	¢	-10.5	-6.9	-4.0	2.0	7.5
EPS Growth	(%)		35%	42%	150%	278%
EPS - diluted		-10.6	-7.0	-4.0	2.0	7.5
Dividend per share		-	-	-	-	-
Payout Ratio		-	-	-	-	-
Franking		-	-	-	-	-

Pricing Multiples	2016	2017	2018	2019	2020
Normalised PER	-13	-40	-38	76	20
Diluted PER	-13	-40	-38	76	20
Market PER (*)	20	19	18	17	16
PER Relative					
EV/Ebitda	-23	-34	-121	20	7
EV/EBIT					
Price/CF	-32	-49	162	20	11
Yield					

Key Ratios	2016	2017	2018	2019	2020
Growth					
Revenue Growth	61%	23%	31%	34%	30%
Ebitda Growth	27%	8%	75%	-	100%
EBIT Growth	43%	14%	42%	145%	100%
Margins					
Ebitda/Sales	-8%	-6%	-1%	4%	7%
EBIT/Sales	-11%	-10%	-5%	2%	5%
Pre-Tax/Sales	-13%	-10%	-4%	2%	5%
Efficiency					
ROE					
ROA					
ROIC					
Leverage					
Net Debt/debt+equity	-107%	-83%	-98%	-102%	-104%
Ebitda/interest cover					
Net Debt/Ebitda					

NB: Redbubble is debt free - negative net debt/equity implies net cash position.

DCF Valuation		
Risk Free Rate	%	6.0%
Equity Risk Premium	%	6.0%
Beta		1.10
Cost of Equity	%	13.2%
Gearing Ratio	%	0%
Cost of Debt	%	5.5%
WACC	%	13.2%
Terminal Growth Rate (Y5)	%	7%
DCF Valuation	$m	415
Value Per Share	$/shr	1.81

Normalised P&L	2016	2017	2018f	2019f	2020f
Group GTV	143	175	234	314	409
Artists/tax	-28	-34	-49	-66	-86
Revenue to RB	115	141	185	248	322
Fulfiller Costs	-76	-91	-120	-160	-208
Gross Margin to RB	39	50	64	88	114
Operating Costs	38	45	48	53	61
Normalised					
Group EBITDA	-9.0	-8.3	-2.1	10.9	23.4
D&A	-4.0	-6.5	-6.5	-7.1	-8.2
EBIT from operations	-13.0	-14.7	-8.6	3.9	15.2
Finance/Other Income - net	0.1	0.5	0.3	0.3	0.3
Finance Costs - net	-1.8	0.0	0.0	0.0	0.0
Minorities	-	-	-	-	-
Associates	-	-	-	-	-
PBT	-14.7	-14.2	-8.3	4.1	15.5
Tax	-3.4	0.0	0.0	0.0	0.0
NPAT - adj	**-18.1**	**-14.2**	**-8.3**	**4.1**	**15.5**
Sig Items	-2.0	6.7			
NPAT - statutory	**-20.1**	**-7.6**	**-8.3**	**4.1**	**15.5**

Balance Sheet	2016	2017	2018	2019	2020
Cash	48	28	62	95	148
Other ST Assets	2	3	5	5	6
PPE	1	2	2	2	2
Intangibles	7	9	10	12	14
Other LT Assets	3	10	10	10	10
Total Assets	62	51	88	124	180
Borrowings	0	0	0	0	0
Other Liabilities	17	18	25	31	38
Total Liabilities	17	18	25	31	38
Net Assets	46	34	63	93	142
Minorities	0	0	0	0	0

Cash Flows	2016	2017	2018	2019	2020
EBITDA	-9.0	-8.3	-2.1	10.9	23.4
Interest paid**	-1.8	0.0	0.0	0.0	0.0
Interest received	0.3	0.0	0.0	0.0	0.0
Tax Paid	0.0	0.0	0.0	0.0	-9.0
WC change/Other	9.3	18.0	24.8	31.9	30.5
Net Operating Cash Flow	1.8	9.7	22.7	42.8	63.0
Capex	-6.9	-13.0	-7.3	-8.9	-10.8
Other investing cash flow	0.0	0.8	0.0	0.0	0.0
Investing Cash Flow	-6.9	-12.2	-7.3	-8.9	-10.8
Financing Cash Flow	40.4	0.0	0.0	0.0	0.0
Total Cash Flows	35.3	-2.4	15.5	33.9	52.2

** Includes some one-off finance costs

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SOURCE: MORGANS RESEARCH, COMPANY

Setting the pace

Growth rates exceed our forecasts

Redbubble produced a strong first half for FY18 as the company continued to outpace competitors in terms of growth in customer traffic and revenues. Customer visits, gross transaction value (GTV) and revenues were all comfortably ahead of our forecasts. Costs were well under control and the cash balance was $2m better than expected. Promotional and discounting activity resulted in a weaker gross profit margin the December quarter, but the company says GP margin will recover in the second half as new fulfiller discounts kick in. We are pleased with the overall quality of the result and have upgraded our forecasts and valuation. Key highlights of the first half performance:

- RBL grew customer visits 39.3% in the December half (42% in the fourth quarter), leaving the main competitors trailing in a cloud of dust. Over the key Xmas selling period RBL's daily traffic volumes were more than double that of the nearest competitor.
- Fuelled by strong growth in mobile transactions, Gross Transaction Volume (GTV) was up 31.7% (34.7% in Q4) to A$129.8m, A$7.7m ahead of our forecast.
- Mobile GTV grew 61% in the fourth quarter as the company improved its marketing sophistication and some early gains were extracted from the project to slash download speeds. However only 20% of pages were served on the new, faster technology platform in Q4, which suggests that more mobile GTV gains can be expected as RBL moves to serving all pages at faster rates.
- Revenue grew 32% to A$102m (A$4m above our forecast). Revenues grew slower than GTV due to a higher proportion of sales being generated in Europe, where sales taxes are higher.
- Gross Profit Margin dropped 1.5 percentage points to 34.5% due to promotional and discounting activity and a shift in mix. However the company said that it expected GP margin to rebound in the second half as new supplier arrangements kick in.
- Spending on paid acquisition grew 50.7% to A$9.6m, but the company continues to state that all acquired business generates gross profit.
- RBL re-iterated guidance that it expected to report revenue growth of greater than 30% for the full year and to be generating monthly-by-month positive EBITDA in the final months of FY18.

Figure 2: Redbubble first half result summary

		H1 FY17	H1 FY18	Reported Growth Rate
Visits	(m)	91.6	127.5	39.2%
Conversion Rate	(%)	2.21%	2.22%	0.3%
Average Order Value	A$	48.7	45.9	-5.7%
GTV	A$m	98.6	129.8	31.6%
Revenues	A$m	78.7	102.3	30.0%
Gross Profit	A$m	28.3	35.3	24.7%
GP Margin	(%)	36.0%	34.5%	-4%
EBITDA	A$m	0.6	2.6	333.3%
Cash from operations	A$m	16.4	22.8	39%
Cash used in investing	A$m	-4.1	-2.2	-45%
Net cash consumed/produced	A$m	12.3	20.6	67%
Closing cash balance	A$m	54.3	46.3	-15%

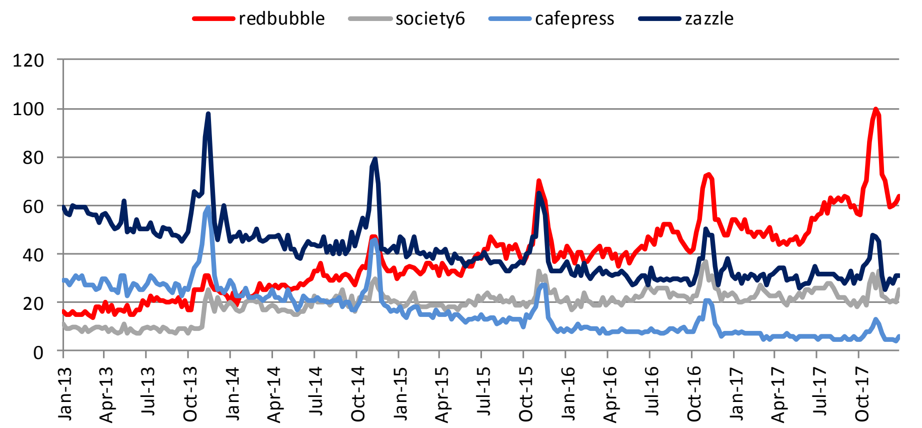
SOURCES: MORGANS, COMPANY REPORTS

Industry still in land grab phase

Although Redbubble has now been operating for 11 years the global online art-driven consumer goods marketplace remains in land grab phase. The challenge for RBL is to become the leading marketplace for trendy consumers and artists while not burning through too much cash or, even better, generating free cash flows to finance further reinvestment. The reward for shareholders in the success scenario is a return of 3x to 10x the current share price.

In the December quarter the company blitzed the competition, notching up 42% growth in consumer traffic while competitors struggled to win double-digit growth and some even saw traffic declines. Search traffic data from Google Trends (shown in the chart below) displays how Redbubble continues to pull ahead. If RBL can maintain its recent performance one or two of its competitors will probably fold. Marketplace businesses benefit enormously from scale economies, and Redbubble seems to be nearing an inflection point.

Figure 3: Redbubble traffic growth compared to near rivals



SOURCES: GOOGLE TRENDS

Acquisition costs

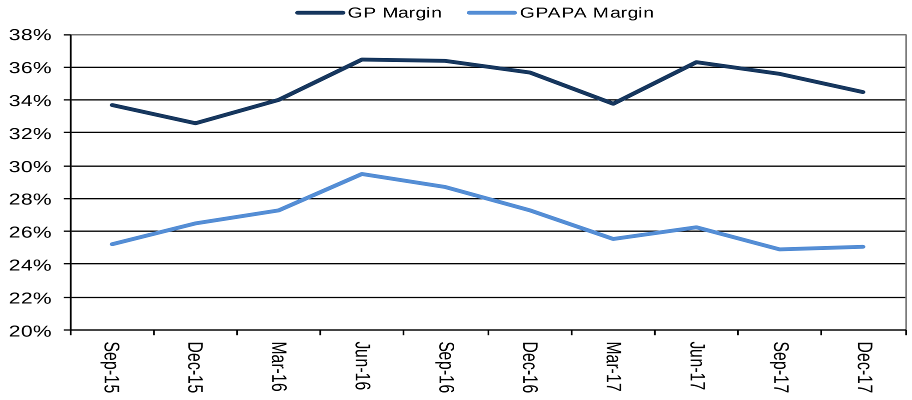
The price of RBL's rise to leadership has been rising customer acquisition costs. The global consumer is going mobile, and mobile traffic is more expensive to acquire. RBL has done a good job in holding gross profit margin above 34% but gross profit margin after paid acquisition (GPAPA) has continued to decline. Since the June 2016 quarter RBL has surrendered 2.6 percentage points in profit margin – roughly $5 million in profit - due to higher customer acquisition costs.

RBL has a number of strategies under way to minimise this profit leakage. Better targeting of consumers (less wasted marketing) and growing conversion rates through improving customer experience are some of the strategies. Dramatically lowering page download speeds on mobile devices should lead to big improvements in conversion rates.

RBL has serving roughly 20% of its search query pages on a new and much faster technology platform in the December quarter. We are now able to download most t-shirt queries onto an Apple iPhone in under three seconds, which compares with 8-11 seconds the same time a year ago. If RBL can continue to maintain the recent rate of improvement in its consumer experience, some of the lost GPAPA margin could be clawed back over the next 2-3 years.

Management said that it expects GP margin to be better in the second half of FY18 due to the negotiation of better supplier terms. But to get real bang for its buck, RBL needs to keep chipping away at the cost of customer acquisition.

Figure 4: Gross margin before and after paid acquisition costs



SOURCES: MORGANS, COMPANY REPORTS

Changes to forecasts

We have revised our profit forecasts to reflect the trends seen in the second half of calendar 2017. We are now more confident of escalating profits and free cash flows from FY19 and have made adjustments accordingly. Changes to our forecasts are shown in the following table:

Figure 5: Changes to profit forecasts

		FY18	FY19	FY20	FY21	FY22
Revenues						
Former	A$m	179.8	232.1	301.0	372.9	456.2
Revised	A$m	184.6	247.7	322.3	412.8	520.9
Gross Margin						
Former	A$m	64.7	83.8	108.9	135.3	166.0
Revised	A$m	64.3	87.5	114.1	146.1	184.4
EBITDA						
Former	A$m	-1.9	9.4	23.9	39.6	58.0
Revised	A$m	-2.1	10.9	23.4	39.2	60.3
NPAT - adj						
Former	A$m	-8.4	1.3	14.1	19.7	31.5
Revised	A$m	-8.3	4.1	15.5	21.0	34.9
NPAT - reported						
Former	A$m	-8.4	1.3	14.1	19.7	31.5
Revised	A$m	-8.3	4.1	15.5	21.0	34.9
EPS						
Former	¢	-4.1	0.6	6.8	9.5	15.1
Revised	¢	-4.0	2.0	7.5	10.1	16.7

SOURCES: MORGANS, COMPANY REPORTS

Change to DCF valuation

Our discounted cash flow valuation has increased to A$1.81 per share, up from A$1.52 per share. The increase in valuation is caused by the increase in our forecasts and a decision to reduce our WACC assumption to 13.2% (from 14.4%), due to the decreasing levels of operational and financial risk evident in the most recent results. The assumptions underlying our DCF valuation are shown in the following table.

Figure 6: Revised discounted cash flow valuation

Year ended 30 June	2018	2019	2020	2021	2022	Modelling Assumptions	
A$m						Risk Free Rate	6.0%
EBIT	(9)	4	15	30	49	Equity Risk Premium	6.0%
D&A	*7*	*7*	*8*	*10*	*11*	Company Beta	1.10
Ebitda	(2)	11	23	39	60	Cost of Equity	13.2%
Capex	-7	-9	-11	-12	-13	Debt %	0%
WC Change	0	0	0	0	0	Cost of Debt	5.5%
Interest						Tax Rate	30%
Tax	0	0	0	-9	-15	WACC	13.2%
Free Cash Flow	(9)	2	13	18	32	Long Term growth rate	7.0%
Other adjustments	2.7	3	3	4	4	Implied TV Multiple	16
Free Cash Flow	(7)	5	16	22	36	Discounted Terminal Value	331
						NPV $	385
Discount Factor	1.00	0.87	0.75	0.65	0.57		
NPV of Free Cash Flow	-6.6	4.4	12.1	14.3	20.5		
NPV of Terminal Value					331		
NPV					385		
Cash/other					20		
Option premiums payable					10		
Total Present Value					415		
FD Shares Out					229		
NPV/Share					1.81		

SOURCES: MORGANS ESTIMATES

Revised price target

Our price target – derived from a blend of DCF valuation and multiple-based methods – has increased to A$1.76 per share (up from A$1.39/share). The increase arises because of the increased DCF valuation and because we have increased the multiples we believe are applicable to the EV/Sales method to 1.9x to 2.0x sales (up from 1.6x to 1.7x sales) and the multiples we believe are applicable to the EV/Gross Margin method to 5.7x to 5.9x gross margin (up from 5.0 to 5.5x gross margin). Although increased, the new multiples still represent deep discounts to global peer group multiples, reflecting the fact that RBL has yet to reach cash flow break even. The calculation of our revised valuation and price target is shown in the following table. Risks of our revised price target being achieved are set out in the risks and catalysts section below.

Figure 7: Revised price target calculation

		Low Value **A$m**	High Value **A$m**
DCF	WACC @13.2%	415	478
EV/sales	(1.9x - 2.0x)	351	369
EV/GM	(5.7x - 5.9x)	367	380
Average		377	409
Shares Out (fd)		224	224
Value/share		1.69	1.83
Mid Point Value		1.76	

SOURCES: MORGANS ESTIMATES

Risks and catalysts

Risks to RBL include: 1) failure to grow GTV and revenue at the expected rate; 2) Slower roll-out of performance improvement initiatives; 3) deterioration of foreign exchange rates; 4) Further increases in mobile customer acquisition costs and; 5) irrational competitor behaviour. Potential near term catalysts include: 1) better GTV and gross margin growth rates; 2) a strong consumer response to the current growth initiatives, especially mobile user experience and; 3) competitors falling behind in terms of product range and user experience.

Investment view

RBL operates a fast-growing global marketplace in art-inspired consumer goods. In our view the global market potential for its merchandise is highly attractive. The company has yet to reach cash-flow break even and is thus High Risk. However successful implementation of the current strategy would deliver substantial returns commensurate with this risk. As the stock trades below our revised valuation and price target, we maintain an ADD recommendation

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Regulatory disclosures

Analyst owns shares in the following mentioned company(ies): Redbubble

Recommendation structure

For a full explanation of the recommendation structure, refer to our website at http://www.morgans.com.au/research_disclaimer

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For analyst qualifications and experience, refer to our website at http://www.morgans.com.au/research-and-markets/our-research-team

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http://www.morgans.com.au/research-and-markets/company-analysis/EX-100-Companies-under-coverage

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