Redbubble

Deflated but life goes on

HOLD (previously ADD)

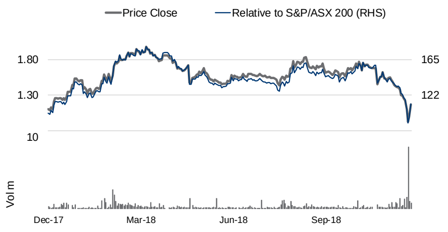
Current price:	A$1.17
Target price: ▼	A$1.19
Previous target:	A$1.91
Up/downside:	2.5%
Reuters:	RBL.AX
Bloomberg:	RBL AU
Market cap:	US$217.8m
	A$298.4m
Average daily turnover:	US$0.39m
	A$0.53m
Current shares o/s	212.9m
Free float:	70.0%

Key changes in this note

FY20F EBITDA down by 16%.

FY21F EBITDA down by 20%.

FY22F EBITDA down by 19%.



Source: Bloomberg

Price performance	1M	3M	12M
Absolute (%)	-22.3	-31.1	11
Relative (%)	-19.9	-20.3	16.1

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Analyst(s) own shares in the following stock(s) mentioned in this report:

– Redbubble

- We have reduced our forecasts and valuation to reflect near-term challenges caused by continuing changes to Google's search engine algorithms.
- Assuming a slow recovery in the share of unpaid visitors our valuation and price target decline to A$1.19 (from A$1.91).
- If RBL can restore former levels of unpaid customer growth (~30%), there is significant upside potential to our valuation.
- As the share price trades close to our revised price target – set by the DCF valuation – our recommendation is lowered to HOLD (from ADD).

Google changes make life harder

We have lowered our RBL forecasts and valuation to reflect the impact of recent changes to Google's search engine algorithms. We have also included, for the first time, forecasts for the TeePublic business acquired on November 6. While the TeePublic acquisition was mildly accretive to earnings, changes to our overall forecasts are lower as we are now factoring in slower top line growth and a higher proportion of paid traffic. Overall the Redbubble business model is slightly deflated – but not broken – by the Google changes. Life gets tougher but even on our heavily marked-down assumptions the company could generate substantial free cash flows.

Changes to forecasts, valuation

Our EBITDA forecasts for FY20, FY21 and FY22 are reduced by 16%, 20% and 19% respectively. Our DCF valuation – which sets the price target – falls to A$1.19 from A$1.91. If RBL can restore former levels of unpaid customers there is upside to our numbers, but in the short term we remain cautious.

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; 5) further unfavourable changes in Google algorithms; and 6) 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; 3) no further adverse changes to Google algorithms; and 4) 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 therefore high risk, although risks will diminish greatly if the company hits FY19 guidance. Successful implementation of the current strategy would deliver substantial returns commensurate with this risk. As the stock trades in line with our revised price target, we downgrade to a HOLD recommendation (from ADD).

Financial Summary	Jun-17A	Jun-18A	Jun-19F	Jun-20F	Jun-21F
Revenue (A$m)	141.0	182.8	257.7	354.9	460.3
Operating EBITDA (A$m)	-8.07	-7.29	0.06	9.40	19.43
Net Profit (A$m)	-7.36	-13.79	-11.12	-0.72	8.14
Normalised EPS (A$)	(0.061)	(0.059)	(0.029)	(0.003)	0.029
Normalised EPS Growth	(24.2%)	(4.2%)	(50.1%)	(91.3%)	
FD Normalised P/E (x)	NA	NA	NA	NA	36.65
DPS (A$)	-	-	-	-	-
Dividend Yield	0%	0%	0%	0%	0%
EV/EBITDA (x)	NA	NA	5,548	33	15
P/FCFE (x)	NA	NA	NA	NA	34.99
Net Gearing	(82.6%)	(79.4%)	(27.2%)	(23.7%)	(35.9%)
P/BV (x)	7.22	9.27	3.32	3.65	3.26
ROE	(35.5%)	(45.7%)	(14.3%)	(0.8%)	9.4%
% Change In Normalised EPS Estimates			20%	(131%)	(54%)
Normalised EPS/consensus EPS (x)			2.26	-0.12	0.48

SOURCE: MORGANS, COMPANY REPORTS

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Figure 1: Financial summary

ASX Code	RBL	Share Price	A$	1.24
Issued shares (m)	256	Recommendation:		HOLD
Market Capital (A$m)	316	Blended Valuation:		1.19
		Price Target:		1.19
		TSR:		-3.3%

Key Financials		2017	2018E	2019F	2020F	2021F
Reported NPAT	A$m	-7	-14	-11.1	-0.7	8.1
Normalised NPAT	A$m	-14	-14	-8.3	-0.7	8.1
EPS - reported	¢	-3.6	-6.5	-4.3	-0.3	3.2
EPS - normalised	¢	-6.8	-6.5	-3.2	-0.3	3.2
EPS Growth	(%)	89%	-24%	-4%	-50%	3977%
EPS - diluted		-6.9	-6.5	-3.5	-0.3	3.2
Dividend per share		-	-	-	-	-
Payout Ratio		-	-	-	-	-
Franking		-	-	-	-	-

Pricing Multiples	2017	2018	2019	2020	2021
Normalised PER	-36	-20	-30	-456	41
Diluted PER	-36	-20	-30	-456	41
Market PER (*)	18	17	16	15	14
PER Relative					
EV/Ebitda	-30	-35	5548	33	15
EV/EBIT					
Price/CF	-43	-44	81	26	13
Yield					

Key Ratios	2017	2018	2019	2020	2021
Growth					
Revenue Growth	23%	30%	41%	38%	30%
Ebitda Growth	10%	10%	-	-	107%
EBIT Growth	12%	3%	39%	88%	830%
Margins					
Ebitda/Sales	-6%	-4%	0%	3%	4%
EBIT/Sales	-10%	-8%	-3%	0%	2%
Pre-Tax/Sales	-10%	-8%	-3%	0%	2%
Efficiency					
ROE					
ROA					
ROIC					
Leverage					
Net Debt/debt+equity	-83%	-79%	-27%	-24%	-36%
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)	%	7.0%
DCF Valuation	$m	339
Value Per Share	$/shr	1.19

Normalised P&L	2017	2018	2019f	2020f	2019f
Group GTV	175	231	326	449	583
Artists/tax	-34	-49	-68	-94	-122
Revenue to RB	141	183	258	355	460
Fulfiller Costs	-91	-119	-166	-228	-295
Gross Margin to RB	50	64	92	127	165
Operating Costs	44	54	68	85	103
Normalised					
Group EBITDA	-8.1	-7.3	0.1	9.4	19.4
D&A	-6.5	-6.8	-8.6	-10.5	-11.7
EBIT from operations	-14.5	-14.1	-8.6	-1.1	7.7
Finance/Other Income - net	0.5	0.3	0.3	0.3	0.5
Finance Costs - net	0.0	0.0	0.0	0.0	0.0
Minorities	-	-	-	-	-
Associates	-	-	-	-	-
PBT	-14.0	-13.8	-8.3	-0.7	8.1
Tax	0.0	0.0	0.0	0.0	0.0
NPAT - adj	**-14.0**	**-13.8**	**-8.3**	**-0.7**	**8.1**
Sig Items	6.7		-2.8		
NPAT - statutory	**-7.4**	**-13.8**	**-11.1**	**-0.7**	**8.1**

Balance Sheet	2017	2018	2019	2020	2021
Cash	28	21	24	19	33
Other ST Assets	3	3	6	7	8
PPE	2	4	2	2	2
Intangibles	9	11	14	17	20
Other LT Assets	10	15	15	15	15
Total Assets	51	54	120	119	136
Borrowings	0	0	0	0	0
Other Liabilities	18	27	30	37	45
Total Liabilities	18	27	30	37	45
Net Assets	34	27	90	82	92
Minorities	0	0	0	0	0

Cash Flows	2017	2018	2019	2020	2021
EBITDA	-8.1	-7.3	0.1	9.4	19.4
Interest paid**	0.0	0.0	0.0	0.0	0.0
Interest received	0.0	0.0	0.0	0.0	0.0
Tax Paid	0.2	0.0	0.0	0.0	-6.2
WC change/Other	3.8	9.6	7.5	6.7	1.9
Net Operating Cash Flow	-4.4	2.3	7.6	16.1	27.6
Capex	-8.9	-9.3	-10.9	-12.8	-14.1
Other investing cash flow	0.0	0.0	-49.3	-8.4	0.0
Investing Cash Flow	-8.9	-9.3	-60.2	-21.2	-14.1
Financing Cash Flow	-0.1	1.1	55.8	0.0	0.0
Total Cash Flows	-13.4	-5.8	3.2	-5.1	13.5

** Includes some one-off finance costs

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SOURCE: MORGANS RESEARCH, COMPANY

Deflated but life goes on

Google changes make life harder

We have revised our Redbubble forecasts and valuation to reflect the impact of recent changes to the mix of paid and unpaid customer traffic caused by the recent changes to Google search engine algorithms. We have also included, for the first time, forecasts for the TeePublic business acquired on November 6. While the TeePublic acquisition was mildly accretive to earnings, changes to our overall forecasts are lower as we are now factoring in slower top line growth and a higher proportion of paid traffic. Key observations on the company's recent announcements:

- TeePublic is a sensible bolt-on acquisition that should add economies of scale over time. Using the economies of scale of a larger revenue base should enable Redbubble to obtain more favourable terms from suppliers and shippers. Running two separate brands off a single fulfilment and technology platform should deliver competitive strengths that, over time, rivals will find hard to emulate.
- Google continuously changes its search engine algorithms and will continue to do so in future. Some changes have had positive effects on RBL's unpaid traffic volumes and others have had negative effects.
- The precipitous drop in unpaid visits to RBL's sites in October was at the extreme end of outcomes for algorithm changes and did not appear to be targeted. All websites that we regard to be true competitors to Redbubble experienced a downturn in traffic volumes in October.
- There has been some speculation that Google algorithm changes were designed to steer more visitors to Google shopping links (essentially paid ads) and to force online marketplaces to pay more for traffic. As Google and Facebook run out of room in which to expand their share of the global online advertising pie in terms of volumes, yield enhancement will become a higher priority.
- We should expect that Google and Facebook will continue to drive up the cost of customer acquisition and to make it harder to obtain unpaid traffic. Redbubble and others like it will need to increase the level of sophistication devoted to customer acquisition.
- Roughly two thirds of Redbubble's unpaid customer traffic comes from Google search queries. For the immediate future at least Redbubble has to work within that constraint.
- Redbubble has avoided the temptation to ramp up paid customer acquisition to cover the loss of unpaid customers. The reasons behind this are simple – paid customers return less than half the gross margin of unpaid customers.
- We anticipate that Redbubble will manage operating costs tightly from now on to minimise the P&L damage caused by the loss of unpaid customers.
- Redbubble has maintained guidance for FY19, but with a caveat that guidance may be changed if the company is unable to restore gross transaction growth to former levels and restore the unpaid customer mix to an acceptable level. So far the signs are encouraging, but in our view it is unwise to wager that the company can meet its targets of being EBITDA and operating cash flow positive this financial year.
- Overall the Redbubble business model is slightly deflated – but not broken – by the Google changes. Life gets tougher but even on our heavily marked-down assumptions the company could generate substantial free cash flows.

Changes to forecasts

We have revised our forecasts to reflect multiple assumption changes since our last (pre-TeePublic) forecasts were published. Overall the TeePublic deal was slightly EPS accretive but this positive impact was outweighed by the negative assumption changes made as a result of the Google algorithm changes. Changes to our forecasts are summarised in the table below. The following points summarise the main changes to forecasting assumptions:

- We have reduced our pre-TeePublic gross customer volume and gross transaction volume growth assumptions by five percentage points in F19 and FY20 as we assume that growth in unpaid customers will be harder to achieve. However we increase our volume growth assumptions by 5 percentage points from FY21 onwards due to the positive impact of the Tee-Public integration and the benefits of shared platforms.
- Overall the impact on our (ex-TP) volume assumptions is negative as the starting base for our volume growth forecasts (FY19 and FY20) is lower than before.
- We assume that customer conversion rates are unchanged – at roughly 2.22% in H1 and 1.69% in H2 from FY19 onwards. Any improvement in conversion rates has a profound impact on profitability.
- We assume a slight improvement in fulfiller costs relative to gross margin due to scale benefits.
- We assume a 58:42 mix of unpaid to paid from H2 FY19 onwards. This represents a shift of two percentage points towards the paid category compared to Q4 in FY18.
- Redbubble's operating costs make a small step change in FY19 due to the TeePublic purchase but costs grow slower than gross margin after paid acquisition (GPAPA) from FY20 onwards.
- Earnings per share is reduced over the entire forecasting period due to the increased number of shares on issue following the TeePublic purchase, and lower earnings on the core business caused by the algorithm changes.

Figure 2: Changes to forecasts

		FY18	FY19	FY20	FY21	FY22
Revenues						
Former	A$m	182.8	245.0	321.2	408.7	515.3
Revised	A$m	182.8	257.7	354.9	460.3	599.6
Gross Margin						
Former	A$m	63.9	87.0	114.4	145.9	184.5
Revised	A$m	63.9	92.0	127.1	165.3	215.9
EBITDA						
Former	A$m	-7.3	0.1	11.2	24.4	41.0
Revised	A$m	-7.3	0.1	9.4	19.4	33.1
NPAT - adj						
Former	A$m	-13.8	-7.8	1.8	13.4	20.1
Revised	A$m	-13.8	-8.3	-0.7	8.1	14.6
NPAT - reported						
Former	A$m	-13.8	-7.8	1.8	13.4	20.1
Revised	A$m	-13.8	-11.1	-0.7	8.1	14.6
EPS						
Former	¢	-6.5	-3.6	0.8	6.3	9.4
Revised	¢	-5.9	-2.9	-0.3	2.9	5.1

SOURCES: MORGANS ESTIMATES

Change to valuation and price target

Our RBL price target is set by our discounted cash flow valuation. Our DCF valuation has declined to A$1.19 per share (from A$1.91 per share) due to: 1) the lower earnings forecasts detailed above; 2) the higher number of shares on issue following the TeePublic acquisition; and 3) a reduction in our terminal year growth rate to 7% (from 7.5%), which reduces the multiple applied to terminal year free cash flows from 18x to 16x. The assumptions underlying our revised valuation are shown in the following table. Risks of our price target and valuation being achieved are detailed in the risks and catalysts section below.

Figure 3: Discounted cash flow valuation

Year ended 30 June	2019	2020	2021	2022	2023	Modelling Assumptions	
A$m						Risk Free Rate	6.0%
EBIT	(9)	(1)	8	20	34	Equity Risk Premium	6.0%
D&A	*9*	*10*	*12*	*13*	*14*	Company Beta	1.10
Ebitda	0	9	19	33	48	Cost of Equity	13.2%
Capex	-11	-21	-14	-15	-17	Debt %	0%
WC Change	3	2	3	3	4	Cost of Debt	5.5%
Interest						Tax Rate	30%
Tax	0	0	0	-6	-10	WACC	13.2%
Free Cash Flow	(8)	(10)	8	15	25	Long Term growth rate	7.0%
Other adjustments	4.2	4.6	5.0	5.4	5.8	Implied TV Multiple	16
Free Cash Flow	(4)	(5)	13	20	30	Discounted Terminal Value	279
						NPV $	319
Discount Factor	1.00	0.87	0.75	0.65	0.57		
NPV of Free Cash Flow	-3.6	-4.7	9.9	13.1	17.3		
NPV of Terminal Value					279		
NPV					319		
Cash/other					20		
Total Present Value					339		
FD Shares Out (FD)					284		
NPV/Share					1.19		

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; 5) further unfavourable changes in Google algorithms; and 6) 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; 3) no further adverse changes to Google algorithms; 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 therefore high risk, although risks will diminish greatly if the company hits FY19 guidance. Successful implementation of the current strategy would deliver substantial returns commensurate with this risk. As the stock trades in line with our revised price target, we downgrade to a HOLD recommendation (was ADD).

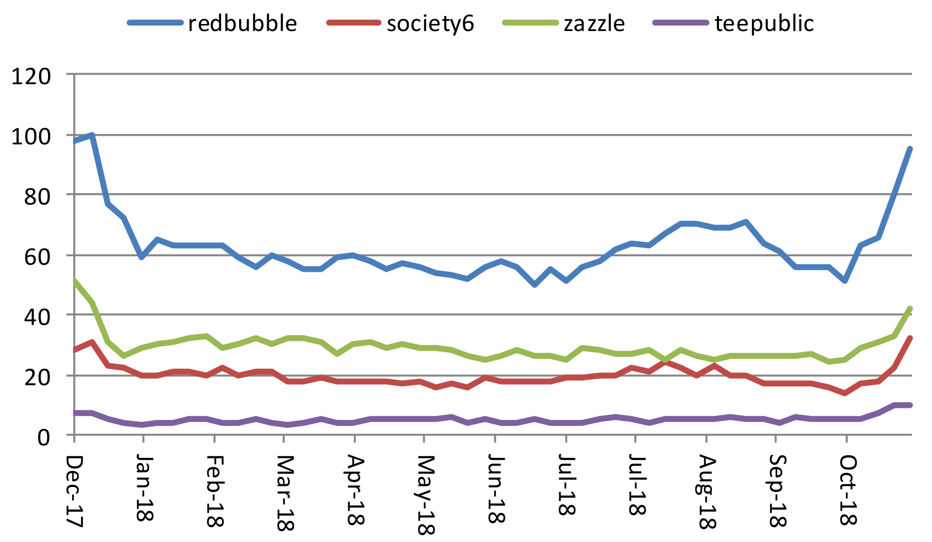
Cash flow and funding

Redbubble's management has stated an aim to be operating cash flow neutral in FY19. While this may now be a stretch target, negative cash flows from now on will be small relative to the company's cash buffer. In addition some of the purchase price of TeePublic is deferred and contingent on performance criteria. The company's significant cash position – likely to exceed A$30m at the end of H1 – suggests that external funding will not be needed in the near term. However should Google continue to make major algorithm changes – which drive up the overall cost of customer acquisition – RBL might need to raise additional capital to maintain healthy liquidity ratios.

Recent traffic trends

Publicly available search query volumes reported by Google Trends suggest that Redbubble's customer traffic volumes have begun to return to former levels. The following chart, downloaded on December 2, suggests that as of the end of last week traffic volumes to Redbubble sites had returned to YOY growth.

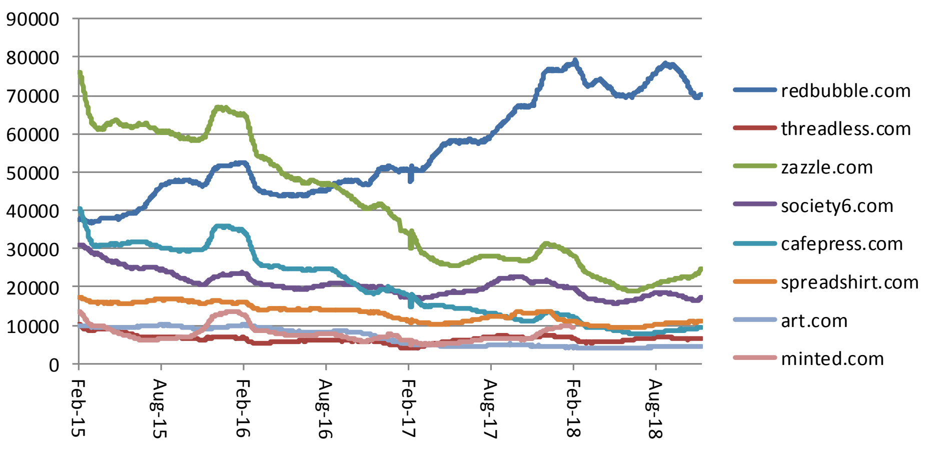
Figure 4: Google Trends search query volumes



SOURCES: GOOGLE TRENDS

Web browsing data from Alexa.com is sometimes regarded as incomplete and has a bias towards desktop browsers, rather than mobile, and may thus not represent the full picture. However Alexa.com data is available in long time series and we have found that these volume measures, over long periods, correspond fairly closely to business performance. The following chart shows Morgans' estimates – using Alexa data – on global relative rankings of daily traffic volumes. While absolute numbers in this chart may be incorrect, the relative performance will generally closely mirror reality. This data suggests – ignoring short-term swings and bumps – that Redbubble has grown its market share relative to all competitors over a period of almost four years.

Figure 5: Alexa estimated daily traffic volumes



SOURCES: ALEXA.COM, MORGANS ESTIMATES

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

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13.06.18