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# Redbubble

## Confidence building

**ADD** (no change)

| | |
|---|---|
| Current price: | A$0.80 |
| Target price: | A$1.27 |
| Previous target: | A$1.21 |
| Up/downside: | 58.9% |
| Reuters: | RBL.AX |
| Bloomberg: | RBL AU |
| Market cap: | US$131.7m |
| | A$166.8m |
| Average daily turnover: | US$0.11m |
| | A$0.15m |
| Current shares o/s | 198.4m |
| Free float: | 70.0% |

Source: Bloomberg

| Price performance | 1M | 3M | 12M |
|---|---|---|---|
| Absolute (%) | -10.1 | -9.6 | -29.5 |
| Relative (%) | -11.1 | -9.2 | -32.8 |

**Ivor RIES**
**T** (61) 3 9947 4182
**E** ivor.ries@morgans.com.au

- Redbubble has forecast 30% constant currency revenue growth and continued improvement in operating performance in FY18.
- The company expects to be trading at stabilised monthly EBITDA break even towards the end of FY18.
- Initiatives to significantly lower average mobile page download speeds will play a critical role in achieving sustained growth.
- Our DCF valuation has increased to A$1.19/share (from A$1.17/share). Our price target has lifted to A$1.27/share (was A$1.21/share). Our ADD recommendation is maintained.

### Result summary

Redbubble yesterday capped its FY17 result with a strong forecast for 30% constant currency revenue growth, steady gross margin and restrained cost growth. The company also stated that it expects to be operating at EBITDA break even on a month-by-month basis in the final months of FY18. The outlook statements reflect a rising level of management confidence that the initiatives now under way will keep delivering sustainable improvements in revenues and gross margin.

### Changes to forecasts

We have revised our forecasts to reflect the company's outlook for FY18 and comments on individual items made during the investor briefings. At the cash level, changes to our forecasts are not as large as they would first appear. We have moved share-based-payments expense from below the EBITDA line to above the EBITDA line, although this is a non-cash item, to reflect statutory treatment. The combined impact of all of the changes on forecast free cash flows – the main driver of our valuation – is immaterial. Our DCF valuation – which uses a weighted average cost of capital of 14.7% – has increased to A$1.19/share (up from A$1.17/share). Our 12-month price target has increased to A$1.27/share, up from A$1.21/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; and 4) 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 well below our valuation and price target, we maintain an ADD recommendation.

| Financial Summary | Jun-16A | Jun-17A | Jun-18F | Jun-19F | Jun-20F |
|---|---|---|---|---|---|
| Revenue (A$m) | 114.6 | 141.0 | 178.5 | 219.1 | 270.5 |
| Operating EBITDA (A$m) | -8.97 | -8.27 | -1.90 | 6.94 | 18.09 |
| Net Profit (A$m) | -20.10 | -7.56 | -8.46 | -1.23 | 8.27 |
| Normalised EPS (A$) | -0.11 | -0.07 | -0.04 | -0.01 | 0.04 |
| Normalised EPS Growth | 143% | (34%) | (42%) | (85%) | |
| FD Normalised P/E (x) | NA | NA | NA | NA | 20.17 |
| DPS (A$) | - | - | - | - | - |
| Dividend Yield | 0% | 0% | 0% | 0% | 0% |
| EV/EBITDA (x) | NA | NA | NA | 20.81 | 7.30 |
| P/FCFE (x) | NA | NA | NA | NA | 18.50 |
| Net Gearing | (108%) | (83%) | (83%) | (85%) | (92%) |
| P/BV (x) | 4.07 | 4.96 | 6.89 | 6.36 | 4.43 |
| ROE | (94.7%) | (39.2%) | (29.2%) | (4.9%) | 25.9% |
| % Change In Normalised EPS Estimates | | | (69%) | (141%) | (2%) |
| Normalised EPS/consensus EPS (x) | | | 1.50 | 5.90 | 0.97 |

SOURCE: MORGANS, COMPANY REPORTS

IMPORTANT DISCLOSURES REGARDING COMPANIES THAT ARE THE SUBJECT OF THIS REPORT AND AN EXPLANATION OF RECOMMENDATIONS CAN BE FOUND AT THE END OF THIS DOCUMENT. MORGANS FINANCIAL LIMITED (ABN 49 010 669 726) AFSL 235410 - A PARTICIPANT OF ASX GROUP

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## Figure 1: Financial summary

| ASX Code | RBL | Share Price | A$ | 0.80 |
|---|---|---|---|---|
| Issued shares (m) | 205.6 | Recommendation: | | ADD |
| Market Capital (A$m) | 164 | Blended Valuation: | | 1.27 |
| | | Price Target: | | 1.27 |
| | | TSR: | | 58.9% |

| Key Financials | | 2016 | 2017 | 2018E | 2019F | 2020F |
|---|---|---|---|---|---|---|
| Reported NPAT | A$m | -20 | -8 | -8 | -1 | 8 |
| Normalised NPAT | A$m | -18 | -14 | -8 | -1 | 8 |
| EPS - reported | ¢ | -11.7 | -3.7 | -4.1 | -0.6 | 4.0 |
| EPS - normalised | ¢ | -10.5 | -6.9 | -4.1 | -0.6 | 4.0 |
| EPS Growth | (%) | | 35% | 41% | 85% | -772% |
| EPS - diluted | | -10.6 | -7.0 | -4.1 | -0.6 | 4.0 |
| Dividend per share | | - | - | - | - | - |
| Payout Ratio | | - | - | - | - | - |
| Franking | | - | - | - | - | - |

| Pricing Multiples | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|
| Normalised PER | -7 | -22 | -20 | -136 | 20 |
| Diluted PER | -7 | -22 | -20 | -136 | 20 |
| Market PER (*) | 20 | 19 | 18 | 17 | 16 |
| PER Relative | | | | | |
| EV/Ebitda | -11 | -16 | -77 | 21 | 7 |
| EV/EBIT | | | | | |
| Price/CF | -17 | -26 | 184 | 16 | 8 |
| Yield | | | | | |

| Key Ratios | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|
| Growth | | | | | |
| Revenue Growth | 61% | 23% | 27% | 23% | 23% |
| Ebitda Growth | 26% | 8% | 77% | - | 100% |
| EBIT Growth | 42% | 14% | 41% | 84% | 100% |
| Margins | | | | | |
| Ebitda/Sales | -8% | -6% | -1% | 3% | 7% |
| EBIT/Sales | -11% | -10% | -5% | -1% | 3% |
| Pre-Tax/Sales | -13% | -10% | -5% | -1% | 3% |
| Efficiency | | | | | |
| ROE | | | | | |
| ROA | | | | | |
| ROIC | | | | | |
| Leverage | | | | | |
| Net Debt/debt+equity | -108% | -83% | -83% | -85% | -92% |
| Ebitda/interest cover | | | | | |
| Net Debt/Ebitda | | | | | |

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

| Normalised P&L | 2016 | 2017 | 2018f | 2019f | 2020f |
|---|---|---|---|---|---|
| Group GTV | 143 | 175 | 220 | 270 | 334 |
| Artists/tax | -28 | -34 | -42 | -51 | -63 |
| Revenue to RB | 115 | 141 | 178 | 219 | 270 |
| Fulfiller Costs | -76 | -91 | -114 | -140 | -173 |
| Gross Margin to RB | 39 | 50 | 64 | 79 | 98 |
| Operating Costs | 48 | 58 | 66 | 72 | 80 |
| ***Normalised*** | | | | | |
| Group EBITDA | -9.0 | -8.3 | -1.9 | 6.9 | 18.1 |
| D&A | -4.0 | -6.5 | -6.8 | -8.4 | -10.1 |
| EBIT from operations | -13.0 | -14.7 | -8.7 | -1.4 | 8.0 |
| Finance/Other Income - net | 0.1 | 0.5 | 0.2 | 0.2 | 0.2 |
| Finance Costs - net | -1.8 | 0.0 | 0.0 | 0.0 | 0.0 |
| Minorities | - | - | - | - | - |
| Associates | - | - | - | - | - |
| PBT | -14.7 | -14.2 | -8.5 | -1.2 | 8.3 |
| Tax | -3.4 | 0.0 | 0.0 | 0.0 | 0.0 |
| **NPAT - adj** | **-18.1** | **-14.2** | **-8.5** | **-1.2** | **8.3** |
| Sig Items | -2.0 | 6.7 | | | |
| **NPAT - statutory** | **-20.1** | **-7.6** | **-8.5** | **-1.2** | **8.3** |

| Balance Sheet | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|
| Cash | 42 | 28 | 20 | 22 | 35 |
| Other ST Assets | 2 | 3 | 4 | 5 | 5 |
| PPE | 1 | 2 | 2 | 2 | 3 |
| Intangibles | 7 | 9 | 12 | 14 | 17 |
| Other LT Assets | 3 | 10 | 10 | 10 | 10 |
| Total Assets | 56 | 51 | 48 | 54 | 70 |
| Borrowings | 0 | 0 | 0 | 0 | 0 |
| Other Liabilities | 17 | 18 | 24 | 27 | 32 |
| Total Liabilities | 17 | 18 | 24 | 27 | 32 |
| Net Assets | 39 | 34 | 24 | 26 | 38 |
| Minorities | 0 | 0 | 0 | 0 | 0 |

| Cash Flows | 2016 | 2017 | 2018 | 2019 | 2020 |
|---|---|---|---|---|---|
| EBITDA | -9.0 | -8.3 | -1.9 | 6.9 | 18.1 |
| 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 | -6.2 |
| WC change/Other | 2.8 | 4.1 | 5.9 | 6.7 | 1.2 |
| Net Operating Cash Flow | -4.7 | -4.2 | 4.0 | 13.6 | 25.5 |
| Capex | -6.9 | -13.0 | -9.6 | -11.3 | -13.2 |
| Other investing cash flow | 0.0 | 0.8 | 0.0 | 0.0 | 0.0 |
| Investing Cash Flow | -6.9 | -12.2 | -9.6 | -11.3 | -13.2 |
| Financing Cash Flow | 40.4 | 0.0 | 0.0 | 0.0 | 0.0 |
| Total Cash Flows | 28.8 | -16.3 | -5.6 | 2.3 | 12.3 |

** Includes some one-off finance costs

| DCF Valuation | | |
|---|---|---|
| Risk Free Rate | % | 6.0% |
| Equity Risk Premium | % | 6.0% |
| Beta | | 1.23 |
| Cost of Equity | % | 14.7% |
| Gearing Ratio | % | 0% |
| Cost of Debt | % | 5.5% |
| WACC | % | 14.7% |
| Terminal Growth Rate (Y5) | % | 8% |
| DCF Valuation | $m | 273 |
| Value Per Share | $/shr | 1.19 |

| Company Contacts | | |
|---|---|---|
| Redbubble Ltd | Chairman | Mr Richard Cawsey |
| Level 3 | Chief Executive | Mr Martin Hosking |
| 271 Collins Street | CFO | Mr Chris Nunn |
| Melbourne | | |
| Australia | | |
| Telephone: +61 3 9650 0138 | | |

**www.redbubble.com.au**

SOURCE: MORGANS RESEARCH, COMPANY

# Confidence building

## Circa 30% constant currency target

Redbubble yesterday capped its FY17 result with a strong forecast for 30% constant currency revenue growth, steady gross margin and restrained cost growth. The company also stated that it expects to be operating at EBITDA break even on a month-by-month basis in the final months of FY18.

The outlook statements reflect a rising level of management confidence that the initiatives now under way will keep delivering sustainable improvements in revenues and gross margin. The guidance implies that management expects the company's competitive position will improve and that customer conversion rates – a key driver of profitability – will stabilise or improve slightly as FY18 progresses. Other key outcomes from yesterday's full-year update:

- The company overcame competitor discounting in FY17 through a 5.3 percentage point increase in the manufacturing margin. The company expects further improvement in manufacturing terms in FY18, enabling gross margin stabilise or slightly improve.
- Paid marketing spend is expected to remain relatively constant – as a percentage of revenues – in FY18. In FY17, paid marketing represented 6.9% of revenues.
- The balance between paid and free traffic (43%/57%) stabilised at year end. As the mobile share of overall traffic continues to grow, this indicates that RBL is getting better at organic traffic generation on mobile.
- RBL is negotiating with some branded content suppliers to allow brand-approved art to be available to consumers for the first time. While how this would work is not clear, if handled in a sensitive manner this move could add 10-15% to revenue over and above our current estimates over a 2-3 year period.
- The company outlined its development pipeline priorities for FY18, with the program aiming to improve search query outcome, improve mobile personalisation, improve customer acquisition productivity and significantly improve download speeds.
- The FY18 result outcome – which had largely been pre-announced – is detailed in the following table.

**Figure 2: Redbubble FY17 performance summary**

| | | FY16 | FY17 | Change | Comments |
|---|---|---|---|---|---|
| Site Visits | (m) | 147.8 | 188.4 | 27% | Stronger growth than peer group |
| Conversion rate | (%) | 1.87% | 1.96% | 5% | Drag from rising mobile share |
| Average Order Value | (A$) | 51.6 | 47.5 | -8% | Mostly currency impact |
| Orders delivered | (m) | 2.77 | 3.69 | 33% | |
| Selling artists | (000) | 154 | 233 | 51% | Stronger than peer group |
| Fulfillment locations | (no) | 18 | 24 | 33% | |
| Unique customers | (m) | 2.2 | 2.9 | 32% | |
| Repeat customers | (m) | 0.6 | 0.9 | 50% | Key leading indicator |
| Gross transaction Value | (A$m) | 142.9 | 175.4 | 23% | |
| Revenue | (A$m) | 114.6 | 141 | 23% | |
| Gross Profit | (A$m) | 31.3 | 37.9 | 21% | Affected by competitor discounting |
| EBITDA | (A$m) | -10.7 | -8.1 | -24% | As expected |
| Net Loss | (A$m) | -19.8 | -7.6 | -62% | |
| Capitalised intangibles | (A$m) | 7.4 | 8.9 | 20% | |

SOURCE: MORGANS RESEARCH, COMPANY

## Change to forecasts

We have revised our forecasts to reflect the company's outlook for FY18 and comments on individual items made during the investor briefings. Key changes to our assumptions were: 1) slightly higher constant currency revenue growth, offset largely by a 3.5% negative currency movement in FY18 and also in subsequent years; 2) higher amortisation charges for share based payments;

and 3) slightly higher customer acquisition costs due to rising mobile share of customers.

At the cash level, changes to our forecasts are not as large as they would first appear. We have moved share-based-payments expense from below the EBITDA line to above the EBITDA line, although this is a non-cash item, to reflect statutory treatment. We have increased (non-cash) share-based payment forecasts to reflect an assumption about the level of new staff hired. We may be overly pessimistic in this assumption. RBL has also begun to treat tax losses as an asset and this creates a credit to the P&L statement that we have not yet included in our reported NPAT forecasts. Therefore RBP reported NPAT may actually be a good deal higher than our forecasts. The combined impact of all of the changes on forecast free cash flows – the main driver of our valuation – is immaterial.

**Figure 3: Changes to earnings forecasts**

| | | FY17 | FY18 | FY19 | FY20 | FY21 |
|---|---|---|---|---|---|---|
| **Revenues** | | | | | | |
| Former | A$m | 141.0 | 177.3 | 224.7 | 277.5 | 341.8 |
| Revised | A$m | 141.0 | 178.5 | 219.1 | 270.5 | 333.1 |
| Gross Margin | | | | | | |
| Former | A$m | 50.1 | 63.6 | 80.9 | 99.9 | 123.0 |
| Revised | A$m | 50.1 | 64.2 | 79.0 | 97.9 | 120.9 |
| EBITDA | | | | | | |
| Former | A$m | -5.2 | 2.4 | 11.9 | 22.4 | 35.3 |
| Revised | A$m | -8.3 | -1.9 | 6.9 | 18.1 | 32.1 |
| NPAT - adj | | | | | | |
| Former | A$m | -11.7 | -4.9 | 3.0 | 8.3 | 16.3 |
| Revised | A$m | -14.2 | -8.5 | -1.2 | 8.3 | 14.5 |
| NPAT - reported | | | | | | |
| Former | A$m | -11.7 | -4.9 | 3.0 | 8.3 | 16.3 |
| Revised | A$m | -7.6 | -8.5 | -1.2 | 8.3 | 14.5 |
| EPS | | | | | | |
| Former | ¢ | -5.2 | -2.4 | 1.4 | 4.1 | 7.9 |
| Revised | ¢ | - 7.0 | - 4.1 | - 0.6 | 4.0 | 6.9 |

SOURCES: MORGANS, COMPANY REPORTS

## Change to valuation

Our valuation has increased due to the roll-forward of the base year of our valuation and the forecasting changes outlined above. Our DCF valuation – which uses a weighted average cost of capital of 14.7% – has increased to A$1.19/share (up from A$1.17/share). Our choice of a very high WACC of 14.7% (normally 9.5%-10.5% for most industrial companies) reflects uncertainty around the time when RBL will become self-sustaining from a cash flow perspective. When RBL reaches cash-flow sustainability the company will be de-risked significantly and our WACC will drop to more normal levels, resulting in a change to our valuation.

Risks to our valuation being achieved are set out in the risks and catalysts section below. The line “Other adjustments” in our valuation reflects non-cash share-based payments. The dilutionary impact of share-based payments is included in our model by assuming that 100% of current employee and executive options on issue are vested.

**Figure 4: Redbubble discounted cash flow valuation**

| Year ended 30 June | 2018 | 2019 | 2020 | 2021 | 2022 | Modelling Assumptions | |
|---|---|---|---|---|---|---|---|
| *A$m* | | | | | | Risk Free Rate | 6.0% |
| EBIT | (9) | (1) | 8 | 20 | 28 | Equity Risk Premium | 6.0% |
| *D&A* | *7* | *8* | *10* | *12* | *13* | Company Beta | 1.23 |
| Ebitda | (2) | 7 | 18 | 32 | 41 | Cost of Equity | 14.7% |
| Capex | -10 | -11 | -13 | -15 | -16 | Debt % | 0% |
| *WC Change* | 0 | 0 | 0 | 0 | 0 | Cost of Debt | 5.5% |
| Interest | | | | | | Tax Rate | 30% |
| Tax | 0 | 0 | 0 | 0 | 0 | WACC | 14.7% |
| Free Cash Flow | (12) | (4) | 5 | 18 | 25 | Long Term growth rate | 7.5% |
| Other adjustments | 3.1 | 3 | 3 | 3 | 3 | Implied TV Multiple | 14 |
| Free Cash Flow | (8) | (1) | 8 | 21 | 29 | Discounted Terminal Value | 210 |
| | | | | | | NPV $ | 243 |
| | | | | | | | |
| Discount Factor | 1.00 | 0.85 | 0.73 | 0.62 | 0.53 | | |
| NPV of Free Cash Flow | -8.4 | -0.9 | 6.0 | 12.9 | 15.2 | | |
| NPV of Terminal Value | | | | | 210 | | |
| NPV | | | | | 243 | | |
| Cash/other | | | | | 20 | | |
| Option premiums payable | | | | | 10 | | |
| Total Present Value | | | | | 273 | | |
| FD Shares Out | | | | | 229 | | |
| NPV/Share | | | | | 1.19 | | |

SOURCES: MORGANS ESTIMATES

## Change to price target

Our 12-month price target has increased to A$1.27/share, up from A$1.21/share. Our price target is set by a blend of DCF valuation, EV/Revenues and EV/Gross margin. As RBL is not yet profitable, the EV/Revenue and EV/Gross margin multiples we deploy are at deep discounts to peer group averages. For example, for our EV/Sales valuation we use a multiple range of 1.5x to 1.6x sales, whereas global peers trade on 4.7x revenues. For our EV/Gross margin valuation, we use a multiple range of 4.5x to 5.0x gross margin, whereas global peers currently trade on 7.3x. Risks to our valuation being achieved are set out in the risks and catalysts section below.

**Figure 5: RBL blended valuation**

| | | Low Value | High Value |
|---|---|---|---|
| | | A$m | A$m |
| DCF | WACC @14.7% | 273 | 291 |
| EV/sales | (1.5x - 1.6x) | 268 | 286 |
| EV/GM | (4.5x - 5.0x) | 289 | 301 |
| Average | | 277 | 293 |
| Shares Out | | 224 | 224 |
| Value/share | | 1.24 | 1.31 |
| Mid Point Value | | 1.27 | |

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; and 4) 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 well below our valuation and price target, we maintain an ADD recommendation.

## Key initiatives in FY18 – it's all about speed

Redbubble provided a roadmap for the improvement program for FY18, measures that will see around A$8m invested on improving the consumer experience, increasing revenues and gross margin. Of the many initiatives under way, in our view the plans to improve page download speeds and improve ROI from paid channels have the largest potential to increase sustainable profitability.

On the issue of download speeds, RBL currently delivers an average search query page to the mobile consumer on a 3G network in 11-12 seconds. Amazon is reported to serve most pages to mobile consumers in the US in less than 2 seconds. Recent research shows that 40% of American consumers, the world's least patient net users, will not wait more than four seconds for a mobile web page to download. US companies that have dramatically lowered average page download times have seen sales increases of up to 12%. In other words, if RBL could reach industry best practice today it could add A$25m to revenues and be profitable 12 months ahead of schedule. RBL needs to cut average page download times by more than two thirds. In our view, that is achievable, but it could take 2-3 years to deliver.

**Figure 6: Redbubble performance enhancement program for FY18**

| Initiative | Key Objectives | Planned Outcomes |
|---|---|---|
| ***Find Your Own Thing*** | Faster search platform<br>Better search algorythms<br>Personalised recommendations | More new user conversion<br>More orders per user |
| ***Deeper Relationships*** | Push content, favourites<br>New accounts service<br>More personalised content | Improve revenue per user<br>Better member information |
| ***Global Acquisition*** | Build scale in Germany<br>Optimisation of paid channels<br>Improved channel attribution | Grow German market share<br>More efficient paid channel growth |
| ***Scalability*** | Faster platform for specific products<br>Accelerate product launches<br>Fulfiller expansion | Increase page download speed<br>Boost sales of new products |

SOURCES: REDBUBBLE

### Queensland

| | |
|---|---|
| Brisbane | +61 7 3334 4888 |
| Stockbroking, Corporate Advice, Wealth Management | |
| Brisbane: Edward St | +61 7 3121 5677 |
| Brisbane: Tynan Partners | +61 7 3152 0600 |
| Brisbane: North Quay | +61 7 3245 5466 |
| Bundaberg | +61 7 4153 1050 |
| Cairns | +61 7 4222 0555 |
| Caloundra | +61 7 5491 5422 |
| Gladstone | +61 7 4972 8000 |
| Gold Coast | +61 7 5581 5777 |
| Ipswich/Springfield | +61 7 3202 3995 |
| Kedron | +61 7 3350 9000 |
| Mackay | +61 7 4957 3033 |
| Milton | +61 7 3114 8600 |
| Noosa | +61 7 5449 9511 |
| Redcliffe | +61 7 3897 3999 |
| Rockhampton | +61 7 4922 5855 |
| Spring Hill | +61 7 3833 9333 |
| Sunshine Coast | +61 7 5479 2757 |
| Toowoomba | +61 7 4639 1277 |
| Townsville | +61 7 4725 5787 |

### New South Wales

| | |
|---|---|
| Sydney | +61 2 9043 7900 |
| Stockbroking, Corporate Advice, Wealth Management | |
| Armidale | +61 2 6770 3300 |
| Ballina | +61 2 6686 4144 |
| Balmain | +61 2 8755 3333 |
| Bowral | +61 2 4851 5555 |
| Chatswood | +61 2 8116 1700 |
| Coffs Harbour | +61 2 6651 5700 |
| Gosford | +61 2 4325 0884 |
| Hurstville | +61 2 9570 5755 |
| Merimbula | +61 2 6495 2869 |
| Neutral Bay | +61 2 8969 7500 |
| Newcastle | +61 2 4926 4044 |
| Newport | +61 2 9998 4200 |
| Orange | +61 2 6361 9166 |
| Port Macquarie | +61 2 6583 1735 |
| Scone | +61 2 6544 3144 |
| Sydney: Level 7 Currency House | +61 2 8216 5111 |
| Sydney: Grosvenor Place | +61 2 8215 5000 |
| Sydney Reynolds Securities | +61 2 9373 4452 |
| Wollongong | +61 2 4227 3022 |

### Victoria

| | |
|---|---|
| Melbourne | +61 3 9947 4111 |
| Stockbroking, Corporate Advice, Wealth Management | |
| Brighton | +61 3 9519 3555 |
| Camberwell | +61 3 9813 2945 |
| Domain | +61 3 9066 3200 |
| Geelong | +61 3 5222 5128 |
| Richmond | +61 3 9916 4000 |
| South Yarra | +61 3 8762 1400 |
| Southbank | +61 3 9037 9444 |
| Traralgon | +61 3 5176 6055 |
| Warrnambool | +61 3 5559 1500 |

### Australian Capital Territory

| | |
|---|---|
| Canberra | +61 2 6232 4999 |

### Northern Territory

| | |
|---|---|
| Darwin | +61 8 8981 9555 |

### Tasmania

| | |
|---|---|
| Hobart | +61 3 6236 9000 |

### Western Australia

| | |
|---|---|
| West Perth | +61 8 6160 8700 |
| Stockbroking, Corporate Advice, Wealth Management | |
| Perth | +61 8 6462 1999 |

### South Australia

| | |
|---|---|
| Adelaide | +61 8 8464 5000 |
| Norwood | +61 8 8461 2800 |



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06.07.17