

Redbubble

Surviving algo-itis

ADD (previously HOLD)

Current price:	A\$1.02
Target price:	A\$1.27 ▲
Previous target:	A\$1.19
Up/downside:	25.3%
Reuters:	RBL.AX
Bloomberg:	RBL AU
Market cap:	US\$186.5m A\$260.0m
Average daily turnover:	US\$0.46m A\$0.64m
Current shares o/s	256.2m
Free float:	70.0%

- Tight cost controls and renegotiated supply arrangements enabled Redbubble to overcome the worst effects of the Google algorithm change in the December half-year.
- Revenue growth, operating profit and cash generation were all well ahead of our forecasts.
- While organic traffic growth remains weak, the company has a strategy in place to grow earnings and cash flows.
- Our valuation, which sets the target price, lifts to A\$1.27/share from A\$1.19/share. We upgrade to an ADD recommendation (High Risk).

Tight controls delivered margin uplift

Redbubble produced a preliminary first half result that exceeded our expectations for revenue growth, operating profit and cash generation. The loss of organic growth due to changes in the Google algorithm hurt revenue growth, but the company adjusted swiftly and clawed back lost profit margin through pricing strategies and better deals with suppliers. Gross profit margins – both before and after paid acquisition costs – were far better than we had expected.

Valuation lifts to A\$1.27

We have revised our forecasts to reflect 1) A slower rebound in the growth rate of organic traffic and a commensurate higher proportion of paid traffic over our forecasting period and 2) Tighter control of fulfiller costs and overheads, resulting in slightly higher Gross Profit and GPAPA margins. We have also trimmed capex forecasts slightly. Our DCF valuation, which sets our price target, lifts to A\$1.27 from A\$1.19.

Risks and catalysts

Risks to RBL include: 1) Slowing revenue growth rates; 2) slower roll-out of performance improvement initiatives; 3) deterioration of foreign exchange rates; 4) rising customer acquisition costs; 5) further disruption from Google algorithm changes; and 6) 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; 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 at a discount to our valuation, and the risks associated with the Google algorithm change are now quantifiable, we upgrade to an ADD recommendation (was HOLD).



Price performance	1M	3M	12M
Absolute (%)	16	-30.3	-36.2
Relative (%)	12.1	-32.8	-32.9

Ivor RIES

T (61) 3 9947 4182

E ivor.ries@morgans.com.au

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

– Redbubble

Financial Summary	Jun-17A	Jun-18A	Jun-19F	Jun-20F	Jun-21F
Revenue (A\$m)	141.0	182.8	262.7	331.3	415.0
Operating EBITDA (A\$m)	-8.07	-7.29	1.11	9.60	20.80
Net Profit (A\$m)	-7.36	-13.79	-9.97	0.20	10.65
Normalised EPS (A\$)	(0.061)	(0.059)	(0.026)	0.001	0.038
Normalised EPS Growth	(24%)	(4%)	(56%)		5323%
FD Normalised P/E (x)	NA	NA	NA	1,324	24
DPS (A\$)	-	-	-	-	-
Dividend Yield	0%	0%	0%	0%	0%
EV/EBITDA (x)	NA	NA	216.5	25.3	10.9
P/FCFE (x)	NA	NA	NA	NA	22.38
Net Gearing	(82.6%)	(79.4%)	(40.1%)	(38.6%)	(48.3%)
P/BV (x)	6.29	8.08	2.41	2.55	2.24
ROE	(35.5%)	(45.7%)	(10.7%)	0.2%	9.8%
% Change In Normalised EPS Estimates			12%	128%	33%
Normalised EPS/consensus EPS (x)			1.52	0.05	0.80

SOURCE: MORGANS, COMPANY REPORTS

Figure 1: Financial summary

ASX Code	RBL	Share Price	A\$	1.02
Issued shares (m)	256	Recommendation:		ADD
Market Capital (A\$m)	260	Blended Valuation:		1.27
		Price Target:		1.27
		TSR:		25.3%

Key Financials	2017	2018	2019F	2020F	2021F
Reported NPAT A\$m	-7	-14	-10	0	11
Normalised NPAT A\$m	-14	-14	-7.2	0.2	10.6
EPS - reported ¢	-3.6	-6.5	-3.9	0.1	4.2
EPS - normalised ¢	-6.8	-6.5	-2.8	0.1	4.2
EPS Growth (%)	89%	-24%	-4%	-56%	5323%
EPS - diluted	-6.9	-6.5	-3.1	0.1	4.2
Dividend per share	-	-	-	-	-
Payout Ratio	-	-	-	-	-
Franking	-	-	-	-	-

Pricing Multiples	2017	2018	2019	2020	2021
Normalised PER	-27	-15	-25	1247	23
Diluted PER	-27	-15	-25	1247	23
Market PER (*)	18	17	16	15	14
PER Relative					
EV/Ebitda	-22	-25	182	21	9
EV/EBIT					
Price/CF	-33	-34	16	20	9
Yield					

Key Ratios	2017	2018	2019	2020	2021
Growth					
Revenue Growth	23%	30%	44%	26%	25%
Ebitda Growth	10%	10%	-	-	117%
EBIT Growth	12%	47%	98%	7731%	-100%
Margins					
Ebitda/Sales	-6%	-4%	0%	3%	5%
EBIT/Sales	-10%	-8%	-3%	0%	2%
Pre-Tax/Sales	-10%	-8%	-3%	0%	3%
Efficiency					
ROE					
ROA					
ROIC					
Leverage					
Net Debt/debt+equity	-83%	-79%	-40%	-39%	-48%
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	354
Value Per Share	\$/shr	1.27

Normalised P&L	2017	2018	2019f	2020f	2019f
Group GTV	175	231	328	413	517
Artists/tax	-34	-49	-65	-82	-102
Revenue to RB	141	183	263	331	415
Fulfiller Costs	-91	-119	-166	-208	-261
Gross Margin to RB	50	64	96	123	154
Operating Costs	-58	-71	-95	-113	-134
Normalised					
Group EBITDA	-8.1	-7.3	1.1	9.6	20.8
D&A	-6.8	-8.5	-9.7	-10.6	-11.5
EBIT from operations	-14.1	-7.4	-0.1	10.2	20.4
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	-13.8	-10.0	0.2	10.6	20.9
Tax	0.0	0.0	0.0	0.0	0.0
NPAT - adj	-14.0	-13.8	-7.2	0.2	10.6
Sig Items	6.7	-2.8	-2.8		
NPAT - statutory	-7.4	-13.8	-10.0	0.2	10.6

Balance Sheet	2017	2018	2019	2020	2021
Cash	28	21	43	39	56
Other ST Assets	3	3	6	7	8
PPE	2	4	2	2	2
Intangibles	9	11	13	15	17
Other LT Assets	10	15	15	15	15
Total Assets	51	54	137	136	156
Borrowings	0	0	0	0	0
Other Liabilities	18	27	30	34	41
Total Liabilities	18	27	30	34	41
Net Assets	34	27	108	102	116
Minorities	0	0	0	0	0

Cash Flows	2017	2018	2019	2020	2021
EBITDA	-8.1	-7.3	1.1	9.6	20.8
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	-0.2	0.0	0.0	-6.3
WC change/Other	3.8	9.5	16.1	6.1	2.0
Net Operating Cash Flow	-4.4	2.3	17.2	15.7	29.1
Capex	-8.9	-9.3	-9.2	-11.2	-12.5
Other investing cash flow	0.0	0.0	-46.5	-8.4	0.0
Investing Cash Flow	-8.9	-9.3	-55.7	-19.6	-12.5
Financing Cash Flow	-0.1	1.1	59.2	0.0	0.0
Total Cash Flows	-13.4	-5.8	20.7	-3.9	16.6

** Includes some one-off finance costs

Company Contacts		
Redbubble Ltd	Chairman	Mr Richard Cawsey
Level 3	Chief Executive	Mr Barry Newstead
271 Collins Street	CFO	Mr Chris Nunn
Melbourne		
Australia		
Telephone: +61 3 9650 0138		
www.redbubble.com.au		

SOURCE: MORGANS RESEARCH, COMPANY

Surviving algo-itis

Tight controls delivered margin uplift

Redbubble produced a first half result that exceeded our expectations for revenue growth, operating profit and cash generation. The loss of organic growth due to changes in the Google algorithm hurt revenue growth, but the company adjusted swiftly and clawed back lost profit margin through pricing strategies and better deals with suppliers. Gross profit margins – both before and after paid acquisition costs – were far better than we had expected. Key observations on the preliminary result:

- The Google algorithm change pared back the underlying growth rate – measured in both traffic and transaction values – for the core Redbubble business to 18% in the December quarter. Organic traffic growth post the algo change was in the low single digits, so most of the traffic and transaction value growth was sourced from paid customers.
- Normally a massive shift from organic (unpaid) to paid customers would result in a sharp deterioration on profit margins. This did not occur because Redbubble managed pricing, fulfiller deals and operating costs more aggressively, allowing gross and EBITDA margins to keep expanding.
- RB management indicated yesterday that there was still more room to improve pricing, fulfillment costs and overheads. While revenue momentum may take some time to rebuild, margin expansion remains doable.
- The algorithm is still clearly a problem, with unpaid traffic growth running in low single digits in the new year. It looks as though the task of rebuilding the level of unpaid traffic will take years, not months.
- Pleasingly, even though RB had to increase the proportion of paid traffic in the half year, the conversion rate did not deteriorate and held roughly around 2.2%. Maintaining the conversion rate with such a big traffic mix is a sign of commercial discipline.
- Cash generation was better than expected. While RB's cash flows are seasonal (with strong inflows in H1 and outflows in H2) the company is clearly on track to have a large net cash balance at the end of FY19. Our modelling suggests a current ratio of ~1.7x at the end of FY19.
- RB re-iterated earlier guidance that it expects to be EBITDA and cash flow positive over the full course of FY19. While the level of free cash generation will be modest, it is a good starting point for commencement of FY20.
- Content partnerships with major creative brands owners is still a work in progress and RB will be adopting a slow launch strategy. Based on the tone of management during today's analyst briefing, we do not anticipate a significant revenue lift from partnerships until FY20.

Figure 2: First half performance summary

		H1 FY17	H1 FY18	H1 FY19	Growth Rate	Morgans Forecasts
Visits	(m)	91.6	127.5	179	40%	165.8
Conversion Rate	(%)	2.2%	2.2%	2.2%	-	2.2%
Average Order Value	A\$	48.7	45.9	51.6	-	46.5
GTV	A\$m	98.6	129.8	170.4	31%	171.1
Revenues	A\$m	78.7	102.3	142.6	39%	134.8
Gross Profit	A\$m	28.3	35.3	51.9	47%	48.1
GP Margin	(%)	36.0%	34.5%	35.7%	3%	35.7%
GPAPA	A\$m	21.1	25.7	36.6	42%	35.3
GPAPA Margin	(%)	26.8%	25.1%	25.7%	2%	26.2%
EBITDA - pre SBP	A\$m	0.4	2.6	5.6	120%	4.6
EBITDA - post SBP	A\$m	-1.13	1.05	3.2	205%	2.5
Cash from operations	A\$m	16.4	22.8	26.7	17%	12.5
Cash used in investing	A\$m	-4.1	-2.2	-4.3	91%	-5.2
Net cash consumed/produced	A\$m	12.3	20.6	22.4	9%	7.3
Closing cash balance	A\$m	54.3	46.3	58.8	27%	35

SOURCES: MORGANS, COMPANY REPORTS

Changes to forecasts

Compensations for lower growth

We have revised our forecasts to reflect 1) A slower rebound in the growth rate of organic traffic and a commensurate higher proportion of paid traffic over our forecasting period and 2) Tighter control of fulfiller costs and overheads, resulting in slightly higher Gross Profit and GPAPA margins. The net outcome of these changes are summarized in the following table:

		FY18	FY19	FY20	FY21	FY22
Figure 3: Forecast revisions						
Revenues						
Former	A\$m	182.8	257.7	354.9	460.3	599.6
Revised	A\$m	182.8	262.7	331.3	415.0	511.9
Gross Margin						
Former	A\$m	63.9	92.0	127.1	165.3	215.9
Revised	A\$m	63.9	96.4	122.9	154.3	190.9
EBITDA						
Former	A\$m	-7.3	0.1	9.4	19.4	33.1
Revised	A\$m	-7.3	1.1	9.6	20.8	31.9
NPAT - adj						
Former	A\$m	-13.8	-8.3	-0.7	8.1	14.6
Revised	A\$m	-13.8	-7.2	0.2	10.6	14.7
NPAT - reported						
Former	A\$m	-13.8	-11.1	-0.7	8.1	14.6
Revised	A\$m	-13.8	-10.0	0.2	10.6	14.7
EPS						
Former	¢	-5.9	-2.9	-0.3	2.9	5.1
Revised	¢	-5.9	-2.6	0.1	3.8	5.3

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 increased to A\$1.27 (from A\$1.19) due to changes to our free cash flow forecasts, which included a small reduction in capex forecasts. 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.

Year ended 30 June	2019	2020	2021	2022	2023	Modelling Assumptions				
A\$m						Risk Free Rate	6.0%			
EBIT	(7)	(0)	10	20	34	Equity Risk Premium	6.0%			
D&A	9	10	11	12	13	Company Beta	1.10			
Ebitda	1	10	21	32	47	Cost of Equity	13.2%			
Capex	-9	-20	-12	-14	-15	Debt %	0%			
WC Change	-1	1	3	3	4	Cost of Debt	5.5%			
Interest						Tax Rate	30%			
Tax	0	0	0	-6	-11	WACC	13.2%			
Free Cash Flow	(9)	(9)	11	15	26	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	(5)	(4)	16	21	32	Discounted Terminal Value	291			
						NPV \$	334			
Discount Factor						1.00	0.87	0.75	0.65	0.57
NPV of Free Cash Flow						-5.1	-3.7	12.2	13.5	18.0
NPV of Terminal Value						291				
NPV						334				
Cash/other						20				
Total Present Value						354				
FD Shares Out (FD)						278				
NPV/Share						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; 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 at a discount to our valuation, and the risks associated with the Google algorithm change are now quantifiable, we upgrade to an ADD recommendation (was HOLD).

Queensland

Brisbane	+61 7 3334 4888
Stockbroking, Corporate Advice, Wealth Management	
Brisbane: Edward St	+61 7 3121 5677
Brisbane: Tynan	+61 7 3152 0600
Partners	
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
Holland Park	+61 7 3151 8300
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	
Sydney: Grosvenor	+61 2 8215 5000
Place	
Sydney: Reynolds	+61 2 9373 4452
Securities	
Sydney: Currency	+61 2 8216 5111
House	
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 8215 5079
Merimbula	+61 2 6495 2869
Mona Vale	+61 2 9998 4200
Neutral Bay	+61 2 8969 7500
Newcastle	+61 2 4926 4044
Orange	+61 2 6361 9166
Port Macquarie	+61 2 6583 1735
Scone	+61 2 6544 3144
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

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
Exchange Place	+61 8 7325 9200
Norwood	+61 8 8461 2800
Unley	+61 8 8155 4300

Australian Capital Territory

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

Northern Territory

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

Tasmania

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

Disclaimer

The information contained in this report is provided to you by Morgans Financial Limited as general advice only, and is made without consideration of an individual's relevant personal circumstances. Morgans Financial Limited ABN 49 010 669 726, its related bodies corporate, directors and officers, employees, authorised representatives and agents ("Morgans") do not accept any liability for any loss or damage arising from or in connection with any action taken or not taken on the basis of information contained in this report, or for any errors or omissions contained within. It is recommended that any persons who wish to act upon this report consult with their Morgans investment adviser before doing so. Those acting upon such information without advice do so entirely at their own risk.

This report was prepared as private communication to clients of Morgans and is not intended for public circulation, publication or for use by any third party. The contents of this report may not be reproduced in whole or in part without the prior written consent of Morgans. While this report is based on information from sources which Morgans believes are reliable, its accuracy and completeness cannot be guaranteed. Any opinions expressed reflect Morgans judgement at this date and are subject to change. Morgans is under no obligation to provide revised assessments in the event of changed circumstances. This report does not constitute an offer or invitation to purchase any securities and should not be relied upon in connection with any contract or commitment whatsoever.

Disclosure of interest

Morgans may from time to time hold an interest in any security referred to in this report and may, as principal or agent, sell such interests. Morgans may previously have acted as manager or co-manager of a public offering of any such securities. Morgans affiliates may provide or have provided banking services or corporate finance to the companies referred to in the report. The knowledge of affiliates concerning such services may not be reflected in this report. Morgans advises that it may earn brokerage, commissions, fees or other benefits and advantages, direct or indirect, in connection with the making of a recommendation or a dealing by a client in these securities. Some or all of Morgans Authorised Representatives may be remunerated wholly or partly by way of commission.

Regulatory disclosures

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

Morgans Corporate Limited was a Participating Broker to the placement and entitlement offer of shares in Redbubble Limited and received fees in this regard.

Recommendation structure

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

Research team

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

Research coverage policy

For an overview on the stock selection process, refer to our website at <https://www.morgans.com.au/research-and-markets/company-analysis/Research-Coverage-Policy>

Research independence statement

<https://www.morgans.com.au/Research-Independence-Statement>

Stocks under coverage

For a full list of stocks under coverage, refer to our website at <http://www.morgans.com.au/research-and-markets/company-analysis/ASX100-Companies-under-coverage> and <http://www.morgans.com.au/research-and-markets/company-analysis/EX-100-Companies-under-coverage>

www.morgans.com.au

If you no longer wish to receive Morgans publications please contact your local Morgans branch or write to GPO Box 202 Brisbane QLD 4001 and include your account details.