

Redbubble

Singing the Google blues

REDUCE (previously ADD)

Current price:	A\$0.94
Target price:	A\$0.67
Previous target:	A\$1.27
Downside:	-28.8%
Reuters:	RBL.AX
Bloomberg:	RBL AU
Market cap:	US\$169.8m
	A\$240.8m
Average daily turnover:	US\$0.25m
	A\$0.40m
Current shares o/s	256.2m
Free float:	70.0%

Key changes in this note

FY20F EPS down by 874%.

FY21F EPS down by 54%.

FY22F ROE down by 43%.



Price performance	1M	3M	12M
Absolute (%)	-13	-5.1	-39.6
Relative (%)	-15.9	-13.1	-45.9

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

– Redbubble

- Redbubble continues to struggle from the serious loss of unpaid customer traffic caused by changes to the Google search algorithm.
- The company is working on remedies for the problem but, in our view, conditions will remain tough for the coming 12-18 months.
- Taking a cautious view on the time to achieve a turnaround, we have downgraded earnings forecasts and valuation.
- Our valuation – which sets the price target – drops to A\$0.67 per share (from A\$1.27 per share).
- We downgrade our investment recommendation to REDUCE (from ADD).

“Mr Google gone done me wrong”

Redbubble continues to suffer from the Google Blues – a mournful song that hurts profit margins. Reporting its March quarter results yesterday, Redbubble revealed that it was still struggling to recover the large volume of consumer traffic it lost late last year when Google changed its search algorithms. Guidance for full-year EBITDA and free cash flows was downgraded as the costs of a higher share of paid traffic continues to bite.

Downgrade to forecasts, valuation

We are downgrading our earnings forecasts to reflect 1) Slowing of revenue growth on former forecasts due to slower organic traffic growth and 2) A higher share of traffic generated from paid sources, leading to higher customer acquisition costs than in our earlier forecasts. The above changes, coupled with a reduction in our terminal growth rate to 5.5% (from 7%) see our 12-month target price cut to A\$0.67 (from A\$1.27).

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 is able to recover former levels of organic traffic. Due to our revised share price target being substantially below yesterday's closing price, we now downgrade our recommendation to REDUCE (was ADD).

Financial Summary	Jun-17A	Jun-18A	Jun-19F	Jun-20F	Jun-21F
Revenue (A\$m)	141.0	182.8	261.8	326.6	400.9
Operating EBITDA (A\$m)	-8.07	-7.29	0.78	7.88	15.00
Net Profit (A\$m)	-7.36	-13.79	-10.30	-1.52	4.85
Normalised EPS (A\$)	(0.061)	(0.059)	(0.027)	(0.005)	0.017
Normalised EPS Growth	(24.2%)	(4.2%)	(54.1%)	(79.7%)	
FD Normalised P/E (x)	NA	NA	NA	NA	49.62
DPS (A\$)	-	-	-	-	-
Dividend Yield	0%	0%	0%	0%	0%
EV/EBITDA (x)	NA	NA	301.9	30.6	15.4
P/FCFE (x)	NA	NA	NA	NA	42.34
Net Gearing	(82.6%)	(79.4%)	(28.5%)	(24.2%)	(33.6%)
P/BV (x)	5.82	7.48	2.67	2.90	2.63
ROE	(35.5%)	(45.7%)	(12.8%)	(1.8%)	5.6%
% Change In Normalised EPS Estimates			(5%)	(874%)	(54%)
Normalised EPS/consensus EPS (x)			1.42	-0.91	0.58

SOURCE: MORGANS, COMPANY REPORTS

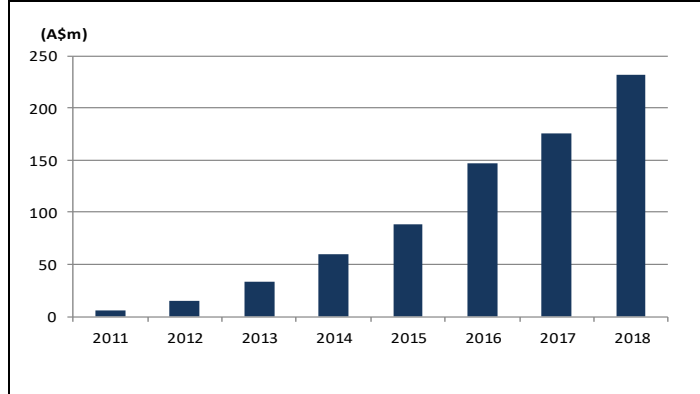
Figure 1: Business snapshot

Redbubble Ltd		RBL AU / RBL.AX		Retailing
Market cap (A\$m):	240.8	Rating:		REDUCE
Shares outstanding (m):	256.2	Price (A\$):		0.94
Free float (%):	70%	Target price (A\$):		0.67
Company website:	www.redbubble.com	Upside/downside to target price (%):		-28.8%

Company description

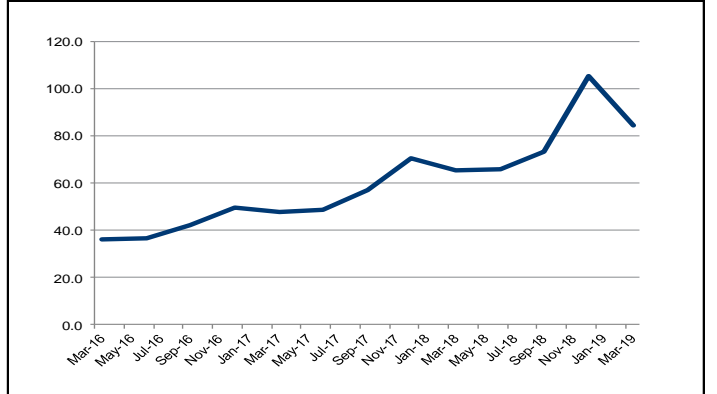
Redbubble operates a global marketplace in art-inspired consumer goods, ranging from tee-shirts and coffee mugs to wall-hangings and home furnishings. The company operates under the Redbubble.com and TeePublic.com brands and sells to customers in most parts of the world. While headquartered in Australia, the company sells more than 85% of its merchandise internationally. The company operates through a broad network of fulfilers who produce and distribute the final product to consumers, usually within three days of the order.

Historic Gross Transaction Values (A\$m)



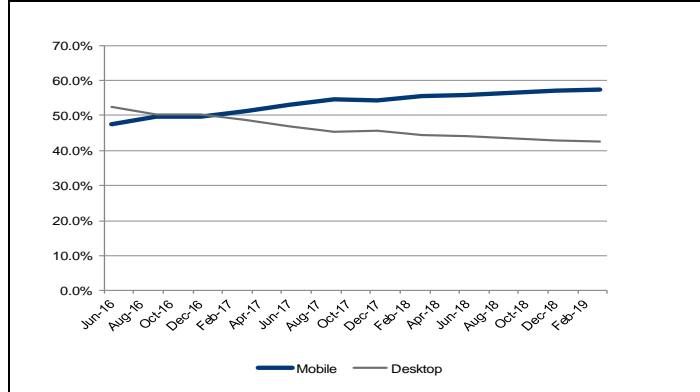
SOURCE: RBL

Quarterly consumer visit history (m)



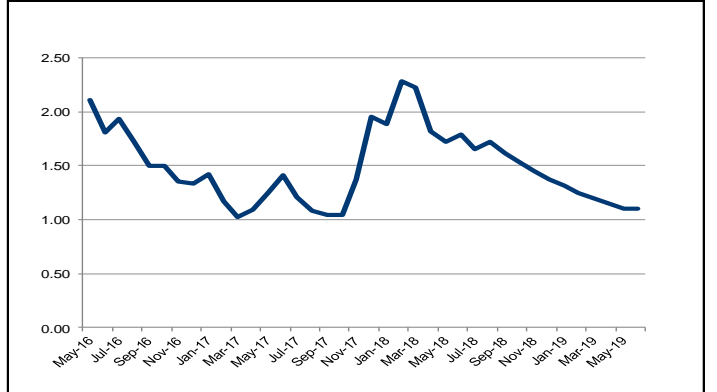
SOURCE: RBL

Source of consumer traffic by device (%)



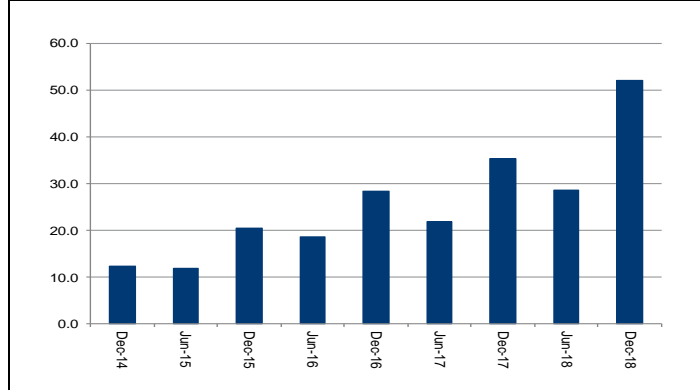
SOURCE: RBL, MORGANS ESTIMATES

RBL market value relative to revenues (X)



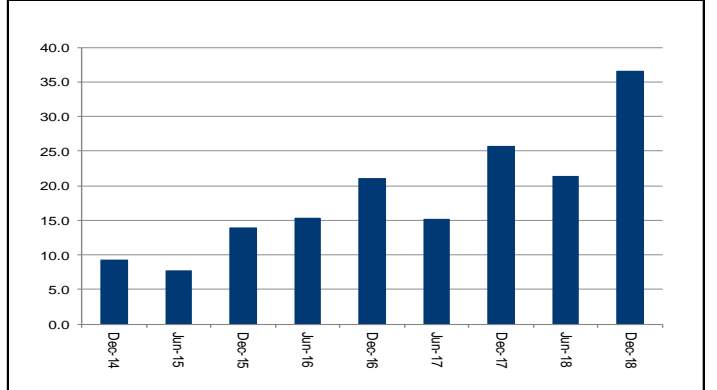
SOURCE: IRESS, MORGANS ESTIMATES

Historic Gross Profit Margin (A\$m)



SOURCE: RBL

GPAPA Margin (A\$m)



SOURCE: RBL. GPAPA = Gross profit after paid advertising

Figure 2: Financial summary

ASX Code	RBL	Share Price	A\$	0.94
Issued shares (m)	256	Recommendation:	REDUCE	
Market Capital (A\$m)	241	Blended Valuation:	0.67	
		Price Target:	0.67	
		TSR:	-28.8%	

Key Financials	2017	2018	2019F	2020F	2021F
Reported NPAT A\$m	-7	-14	-10	-2	5
Normalised NPAT A\$m	-14	-14	-7.5	-1.5	4.9
EPS - reported ¢	-3.6	-6.5	-4.0	-0.6	1.9
EPS - normalised ¢	-6.8	-6.5	-2.9	-0.6	1.9
EPS Growth (%)	89%	-24%	-4%	-54%	-419%
EPS - diluted	-6.9	-6.5	-3.2	-0.6	1.9
Dividend per share	-	-	-	-	-
Payout Ratio	-	-	-	-	-
Franking	-	-	-	-	-

Pricing Multiples	2017	2018	2019	2020	2021
Normalised PER	-29	-16	-25	-172	54
Diluted PER	-29	-16	-25	-172	54
Market PER (*)	18	17	16	15	14
PER Relative					
EV/Ebitda	-23	-27	302	31	15
EV/EBIT					
Price/CF	-35	-36	-207	26	13
Yield					

Key Ratios	2017	2018	2019	2020	2021
Growth					
Revenue Growth	23%	30%	43%	25%	23%
Ebitda Growth	10%	10%	-	-	90%
EBIT Growth	12%	3%	45%	76%	338%
Margins					
Ebitda/Sales	-6%	-4%	0%	2%	4%
EBIT/Sales	-10%	-8%	-3%	-1%	1%
Pre-Tax/Sales	-10%	-8%	-3%	0%	1%
Efficiency					
ROE					
ROA					
ROIC					
Leverage					
Net Debt/debt+equity	-83%	-79%	-28%	-24%	-34%
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)	%	5.5%
DCF Valuation	\$m	186
Value Per Share	\$/shr	0.67

Normalised P&L	2017	2018	2019F	2020F	2021F
Group GTV	175	231	326	407	500
Artists/tax	-34	-49	-65	-81	-99
Revenue to RB	141	183	262	327	401
Fulfiller Costs	-91	-119	-166	-206	-253
Gross Margin to RB	50	64	95	120	148
Operating Costs	-58	-71	-95	-113	-133

Normalised	2017	2018	2019F	2020F	2021F
Group EBITDA	-8.1	-7.3	0.8	7.9	15.0
D&A	-6.5	-6.8	-8.5	-9.7	-10.6
EBIT from operations	-14.5	-14.1	-7.8	-1.8	4.4
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	-10.3	-1.5	4.9	11.9
Tax	0.0	0.0	0.0	0.0	0.0
NPAT - adj	-14.0	-13.8	-7.5	-1.5	4.9
Sig Items	6.7	-2.8	-	-	-
NPAT - statutory	-7.4	-13.8	-10.3	-1.5	4.9

Balance Sheet	2017	2018	2019	2020	2021
Cash	28	21	26	20	31
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	120	117	131
Borrowings	0	0	0	0	0
Other Liabilities	18	27	29	34	40
Total Liabilities	18	27	29	34	40
Net Assets	34	27	90	83	91
Minorities	0	0	0	0	0

Cash Flows	2017	2018	2019	2020	2021
EBITDA	-8.1	-7.3	0.8	7.9	15.0
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	-3.6
WC change/Other	3.8	9.5	2.5	6.0	4.6
Net Operating Cash Flow	-4.4	2.3	3.2	13.9	23.2
Capex	-8.9	-9.3	-9.2	-11.2	-12.5
Other investing cash flow	0.0	0.0	-50.0	-8.4	0.0
Investing Cash Flow	-8.9	-9.3	-59.2	-19.6	-12.5
Financing Cash Flow	-0.1	1.1	59.2	0.0	0.0
Total Cash Flows	-13.4	-5.8	3.2	-5.6	10.7

** Includes some one-off finance costs

Company Contacts		
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www.redbubble.com.au

SOURCE: MORGANS RESEARCH, COMPANY

Singing the Google Blues

“Mr Google gone done me wrong”

Redbubble continues to suffer from the Google Blues – the deep gloom that comes when your best source of profitable customers refuses to play nice. Reporting its March quarter results yesterday, Redbubble said that it was still struggling to recover the large volume of consumer traffic it lost late last year when Google changed its search algorithms. The loss of Google traffic has translated into a marked slowing in the company’s organic traffic, forcing the company to step up the level of paid advertising, with unfavourable consequences for profit margins. Key observations from the quarterly update:

- RBL said that “continuance of the organic search issue” led to lower growth in the March quarter compared to prior quarters. Revenue from unpaid channels grew only 0.7% in the quarter, while revenues from paid channels grew 53.9%.
- The final profit margin on a paid customer (after advertising costs) works out at less than half that of a customer acquired through unpaid channels. As the proportion of paid customers grows, RBL’s margins are squeezed.
- RBL is now applying a number of strategies to mitigate margin erosion. These include trying to obtain other forms of organic traffic (outside of Google), trying to grow the Redbubble App user base, and maintaining tight controls on operating costs.
- RBL still expects that it will be operating EBITDA positive for FY19, but only by a slender margin. This is a downgrade on earlier guidance.
- Even if the company is EBITDA positive for the full year the company expects to be cash flow negative, after the impact of working capital movements. This is a downgrade on earlier guidance.
- RBL now needs a dose of good fortune in implementing its business improvement strategy over the coming 12 months. Without some luck the company will be stuck growing its revenues by 25%-30% a year but struggling to generate meaningful free cash flows.

Downgrade to earnings forecasts

We are downgrading our earnings forecasts to reflect 1) Slowing of revenue growth on former forecasts due to slower organic traffic growth and 2) A higher share of traffic generated from paid sources, leading to higher customer acquisition costs than in our earlier forecasts. The changes to our forecasts are summarised in the following table:

Figure 3: Changes to forecasts						
Revenues						
Former	A\$m	262.7	331.3	415.0	511.9	642.7
Revised	A\$m	261.8	326.6	400.9	492.1	604.2
Gross Margin						
Former	A\$m	96.4	122.9	154.3	190.9	240.3
Revised	A\$m	95.5	120.4	148.2	182.4	224.5
EBITDA						
Former	A\$m	1.1	9.6	20.8	31.9	47.3
Revised	A\$m	0.8	7.9	15.0	22.9	32.3
NPAT - adj						
Former	A\$m	-7.2	0.2	10.6	14.7	24.6
Revised	A\$m	-7.5	-1.5	4.9	8.4	14.1
NPAT - reported						
Former	A\$m	-10.0	0.2	10.6	14.7	24.6
Revised	A\$m	-10.3	-1.5	4.9	8.4	14.1
EPS						
Former	¢	-2.6	0.1	3.8	5.3	8.8
Revised	¢	-	2.7	0.5	1.7	3.0

SOURCES: MORGANS FORECASTS

Downgrade to valuation

Our discounted cash flow valuation – which drives our share price target – has declined to A\$0.67 per share due to 1) Changes to our forecasts outline above and 2) A reduction in our terminal growth rate from 7% to 5.5%. The latter change reduces the valuation multiple applied to terminal year earnings from 16 times to 13 times. Risks to our price target being reached are spent out on the risks and catalysts section on the first page of this report.

Figure 4: Discounted cash flow valuation

Year ended 30 June	2019	2020	2021	2022	2023	Modelling Assumptions	
A\$m						Risk Free Rate	6.0%
EBIT	(8)	(2)	4	11	20	Equity Risk Premium	6.0%
D&A	9	10	11	12	13	Company Beta	1.10
Ebitda	1	8	15	23	32	Cost of Equity	13.2%
Capex	-9	-20	-12	-14	-15	Debt %	0%
WC Change	-15	1	3	3	4	Cost of Debt	5.5%
Interest						Tax Rate	30%
Tax	0	0	0	-4	-6	WACC	13.2%
Free Cash Flow	(23)	(11)	5	9	15	Long Term growth rate	5.5%
Other adjustments	4.2	4.6	5.0	5.4	5.8	Implied TV Multiple	13
Free Cash Flow	(19)	(6)	10	14	21	Discounted Terminal Value	155
						NPV \$	166
Discount Factor	1.00	0.87	0.75	0.65	0.57		
NPV of Free Cash Flow	-19.1	-5.2	7.7	9.3	11.9		
NPV of Terminal Value					155		
NPV					166		
Cash/other					20		
Total Present Value					186		
FD Shares Out (FD)					278		
NPV/Share					0.67		

SOURCES: MORGANS ESTIMATES

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

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