morgans

Redbubble

Pleasant surprise

- Redbubble unveiled a surprisingly strong fourth quarter and announced that the company was looking at a secondary listing of depository shares in the United States.
- The strength of the margin improvement in Q4 of FY19 caught us – and everybody else – by surprise. Tighter control of marketing costs, and lower overhead costs, have boosted expectations for FY20.
- We have upgraded our forecasts to reflect the lower marketing and overhead costs seen in Q4. Due to these and other changes our DCF valuation, which drives our target price, increased to A$1.51 per share, up from A$0.67/share.
- We upgrade to a HOLD recommendation (was REDUCE).

HOLD (previously REDUCE)

Current price:	A$1.46
Target price: ▲	A$1.51
Previous target:	A$0.67
Up/downside:	3.6%
Reuters:	RBL.AX
Bloomberg:	RBL AU
Market cap:	US$258.2m
	A$374.0m
Average daily turnover:	US$0.26m
	A$0.46m
Current shares o/s	256.2m
Free float:	70.0%

Key changes in this note

FY20F EPS up by 126%.

FY21F EPS up by 64%.

FY22F EPS up by 102%.

Source: Bloomberg

Price performance	1M	3M	12M
Absolute (%)	61.3	55.3	-7.3
Relative (%)	58.2	47.4	-16

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

– N/A

Cost controls and efficiency deliver the goods

A concerted drive to reduce costs and improve operating efficiency – especially in customer acquisition costs – enabled Redbubble to deliver a pleasant surprise for investors with the release of preliminary FY19 financials. After suffering a thrashing from a hostile change to the Google search algorithm in late 2018, the global art market operator produced stunning and unexpected leaps in key performance metrics in the second half of the FY19 financial year. There have been material upgrades to our profit forecasts.

Valuation increase to A$1.51/share

Our discounted cash flow valuation – which drives our share price target – has increased to A$1.51 per share, up from A$0.67 per share. The dramatic increase in valuation is caused by 1) the roll-forward of the base forecasting year to FY20; 2) Changes to our forecasts outlined above; and 3) An increase in our terminal growth rate from 5.5% to 8%.

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 prove cash flow self-sufficiency in FY20. Due to the substantial increase in our revised share price target, we upgrade our investment recommendation to HOLD (was REDUCE).

Financial Summary	Jun-18A	Jun-19F	Jun-20F	Jun-21F	Jun-22F
Revenue (A$m)	182.8	257.0	312.0	383.0	470.2
Operating EBITDA (A$m)	-7.29	3.79	9.80	18.13	27.86
Net Profit (A$m)	-13.79	-21.19	0.40	7.98	16.91
Normalised EPS (A$)	(0.059)	(0.016)	0.001	0.029	0.061
Normalised EPS Growth	(4%)	(73%)		1900%	112%
FD Normalised P/E (x)	NA	NA	937.3	46.9	22.1
DPS (A$)	-	-	-	-	-
Dividend Yield	0%	0%	0%	0%	0%
EV/EBITDA (x)	NA	99.57	38.90	20.26	12.34
P/FCFE (x)	NA	NA	NA	41.96	20.69
Net Gearing	(79.4%)	(30.9%)	(28.6%)	(39.3%)	(52.3%)
P/BV (x)	11.62	4.02	4.27	3.77	3.13
ROE	(45.7%)	(7.5%)	0.4%	8.5%	15.5%
% Change In Normalised EPS Estimates		40%	126%	64%	102%
Normalised EPS/consensus EPS (x)		0.65	-0.18	2.21	2.03

SOURCE: MORGANS, COMPANY REPORTS

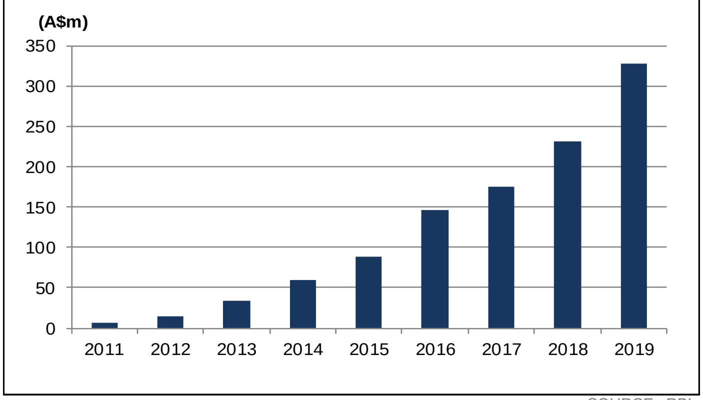
Figure 1: Business snapshot

Redbubble Ltd		RBL AU / RBL.AX	Retailing
Market cap (A$m):	374.0	Rating:	HOLD
Shares outstanding (m):	256.2	Price (A$):	1.46
Free float (%):	70%	Target price (A$):	1.51
Company website:	www.redbubble.com	Upside/downside to target price (%):	3.6%

Company description

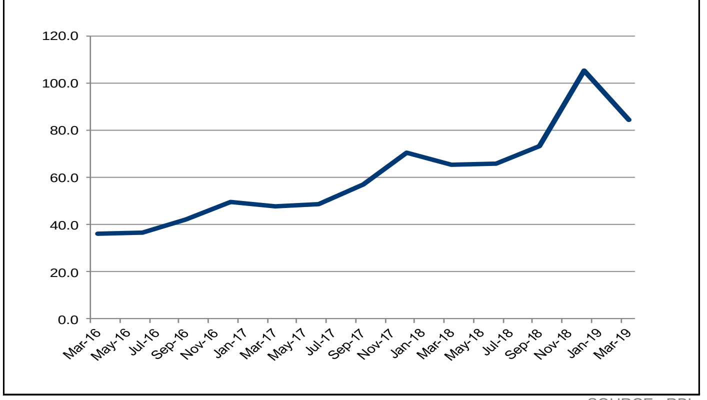
Redbubble operates a global marketplace in art-inspired consumer goods, ranging from tee-shirts and coffee mugs to wall-hangings and home furnishings. The company operates under the Redbubble.com and TeePublic.com brands and sells to customers in most parts of the world. While headquartered in Australia,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

Historic Gross Transaction Values A$m



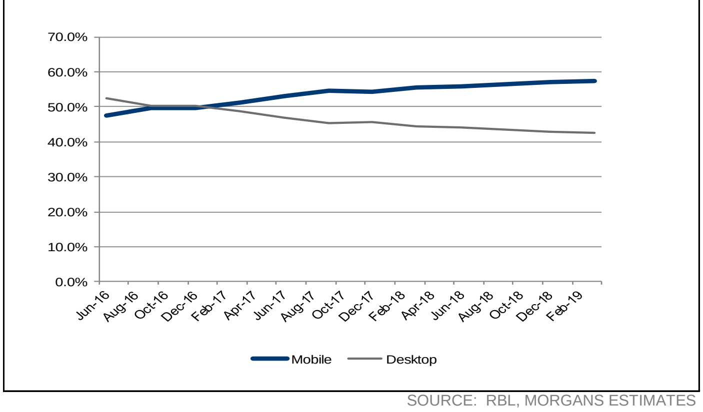
SOURCE: RBL

Quarterly consumer visit history (m)



SOURCE: RBL

Source of consumer traffic by device (%)

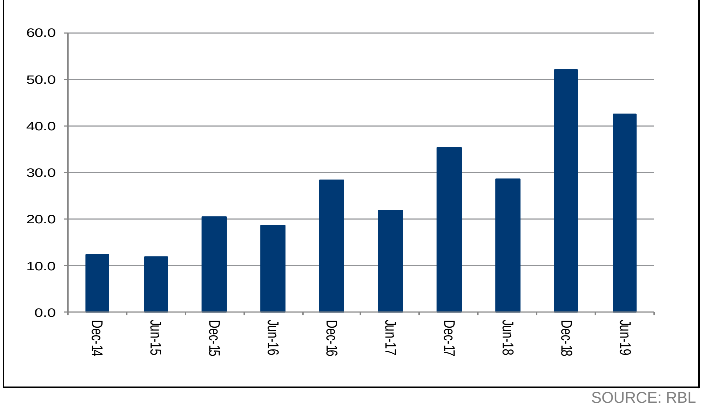


SOURCE: RBL, MORGANS ESTIMATES

RBL market value relative to revenues (X)

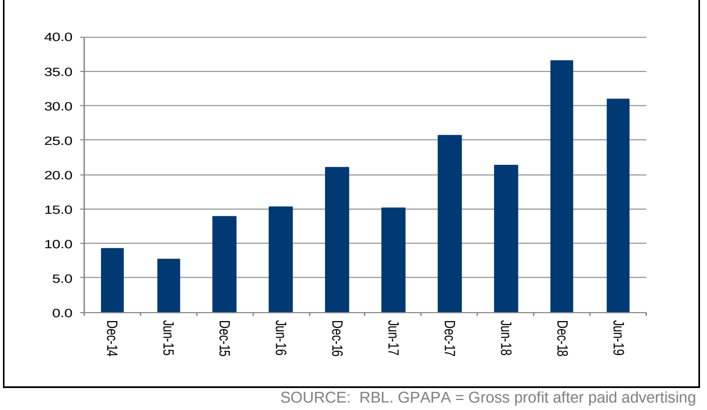
SOURCE: IRESS, MORGANS ESTIMATES

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$	1.46
Issued shares (m)	256	Recommendation:		HOLD
Market Capital (A$m)	374	Valuation		1.51
		Price Target:		1.51
		TSR:		3.6%

Key Financials		2017	2018	2019F	2020F	2021F
Reported NPAT	A$m	-7	-14	-21	0	8
Normalised NPAT	A$m	-14	-14	-4.5	0.4	8.0
EPS - reported	¢	-3.6	-6.5	-8.3	0.2	3.1
EPS - normalised	¢	-6.8	-6.5	-1.8	0.2	3.1
EPS Growth	(%)	89%	-24%	-4%	-73%	1900%
EPS - diluted		-6.9	-6.5	-1.9	0.2	3.1
Dividend per share		-	-	-	-	-
Payout Ratio		-	-	-	-	-
Franking		-	-	-	-	-

Pricing Multiples	2017	2018	2019	2020	2021
Normalised PER	-45	-25	-19	1018	51
Diluted PER	-45	-25	-19	1018	51
Market PER (*)	18	17	16	15	14
PER Relative					
EV/Ebitda	-38	-44	100	39	20
EV/EBIT					
Price/CF	-54	-56	176	33	17
Yield					

Key Ratios	2017	2018	2019	2020	2021
Growth					
Revenue Growth	23%	30%	41%	21%	23%
Ebitda Growth	10%	10%	-	-	85%
EBIT Growth	12%	3%	66%	101%	#######
Margins					
Ebitda/Sales	-6%	-4%	1%	3%	5%
EBIT/Sales	-10%	-8%	-2%	0%	2%
Pre-Tax/Sales	-10%	-8%	-2%	0%	2%
Efficiency					
ROE					
ROA					
ROIC					
Leverage					
Net Debt/debt+equity	-83%	-79%	-31%	-29%	-39%
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)	%	8.0%
DCF Valuation	$m	421
Value Per Share	$/shr	1.51

Normalised P&L	2017	2018	2019f	2020f	2019f
Group GTV	175	231	328	410	503
Artists/tax	-34	-49	-71	-98	-120
Revenue to RB	141	183	257	312	383
Fulfiller Costs	-91	-119	-162	-195	-239
Gross Margin to RB	50	64	95	117	144
Operating Costs	-58	-71	-91	-108	-126
Normalised					
Group EBITDA	-8.1	-7.3	3.8	9.8	18.1
D&A	-6.5	-6.8	-8.5	-9.7	-10.6
EBIT from operations	-14.5	-14.1	-4.7	0.1	7.5
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	-21.2	0.4	8.0	16.9
Tax	0.0	0.0	0.0	0.0	0.0
NPAT - adj	**-14.0**	**-13.8**	**-4.5**	**0.4**	**8.0**
Sig Items	6.7		-16.7		
NPAT - statutory	**-7.4**	**-13.8**	**-21.2**	**0.4**	**8.0**

Balance Sheet	2017	2018	2019	2020	2021
Cash	28	21	29	25	39
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	123	122	139
Borrowings	0	0	0	0	0
Other Liabilities	18	27	30	34	40
Total Liabilities	18	27	30	34	40
Net Assets	34	27	93	88	99
Minorities	0	0	0	0	0

Cash Flows	2017	2018	2019	2020	2021
EBITDA	-8.1	-7.3	3.8	9.8	18.1
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	0.0
WC change/Other	3.8	9.5	2.5	6.1	8.3
Net Operating Cash Flow	-4.4	2.3	6.3	15.9	26.4
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	6.2	-3.7	13.9

** Includes some one-off finance costs

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SOURCE: MORGANS RESEARCH, COMPANY

Pleasant surprise

Cost controls and efficiency drive deliver the goods

A concerted drive to reduce costs and improve operating efficiency – especially in customer acquisition costs – enabled Redbubble to deliver a pleasant surprise for investors with the release of preliminary FY19 financials. After suffering a thrashing from a hostile change to the Google search algorithm in 2018, the global art market operator produced stunning and unexpected leaps in key performance metrics in the second half of the FY19 financial year. Key observations on yesterday's update:

- RBL lifted gross profit margin – before customer acquisition costs - by 1.8 percentage points to 36.8% over FY19. The margin uplift was driven by using economies of scale to negotiate better deals with fulfillers and transport providers, but the benefit was only felt in the final quarter of FY19. The full-year benefit of the new supplier arrangements in FY20. RBL expressed confidence that it could make further steady improvements in gross margin over time.
- Some of the gross margin improvement was attributable to the acquisition of TeePublic, which has historically operated with lower artist expense ratios than the core Redbubble business. However, even after stripping out the impact of this acquisition, RBL made meaningful GP margin gains.
- RBL had good early success in reducing its reliance on paid advertising from Google and finding new marketing channels that delivered new customers at a lower cost. Again the full impact of these changes were not felt in the final quarter of FY19, so FY20 should show a full-year benefit of the productivity improvement.
- RBL is continuing to invest in reducing the average sale cost by investing in growing the number of Redbubble app users and members. IOS app users accounted for 8% of revenues in Q4, up from nothing 18 months earlier. The release of an android app is near.
- Underlying top-line growth of around 18%, represented by 13% constant currency transaction growth at Redbubble and ~45% transaction growth at TeePublic. Redbubble's full-year growth rate was the lowest since public listing, a consequence of the change in the Google algorithm last year. It may be too much to expect significant improvements in the growth rate of each brand in FY20, at least in H1.
- RBL came close to cash flow self-sufficiency in H2 as cash from operations exceeded capital investment. The company now appears to be self-sustaining from a cash flow perspective, able to generate all of its growth capital internally.
- Redbubble said that it would no longer provide specific short-term earnings guidance. The company said that the business is focussed on reaching a milestone of A$1 billion in sales and "current economics demonstrate that this can be achieved profitably." The market may take some time to adapt to a lack of formal guidance.
- The company said that it was looking at a secondary listing in the United States, most likely on the Nasdaq market, most likely in the form of American Depository Receipts (ADRs). The recent flood of listings by marketplace stocks in the US, on much higher revenue multiples that RBL, has made this route attractive.

Changes to forecasts

We have revised our forecasts to reflect 1) A slower overall top-line revenue growth rate, 2) Improved gross margins, 3) More efficient marketing expenditure and 4) Lower operating costs. These changes have resulted in greatly improved EBITDA forecasts compared to our former forecasts. The outcome of the changes mentioned above are displayed in the following table:

Figure 3: Forecast Revisions

			FY19	FY20	FY21	FY22	FY23	FY24
Revenues								
Former	A$m		261.8	326.6	400.9	492.1	604.2	741.7
Revised	A$m		257.0	312.0	383.0	470.2	577.2	697.1
Gross Margin								
Former	A$m		95.5	120.4	148.2	182.4	224.5	276.4
Revised	A$m		94.5	117.3	144.4	177.7	218.7	264.9
EBITDA								
Former	A$m		0.8	7.9	15.0	22.9	32.3	43.6
Revised	A$m		3.8	9.8	18.1	27.9	40.0	53.8
NPAT - adj								
Former	A$m		-7.5	-1.5	4.9	8.4	14.1	21.2
Revised	A$m		-4.5	0.4	8.0	16.9	27.9	32.4
NPAT - reported								
Former	A$m		-10.3	-1.5	4.9	8.4	14.1	21.2
Revised	A$m		-21.2	0.4	8.0	16.9	27.9	32.4
EPS - adj								
Former	¢		-3.2	-0.6	1.9	3.3	5.5	5.5
Revised	¢	-	1.6	0.1	2.9	6.1	10.0	11.6

SOURCES: MORGANS ESTIMATES

Changes to valuation and price target

Our discounted cash flow valuation – which drives our share price target – has increased to A$1.51 per share, up from A$0.67 per share. The dramatic increase in valuation is caused by 1) the roll-forward of the base forecasting year to FY20; 2) Changes to our forecasts outlined above; and 3) An increase in our terminal growth rate from 5.5% to 8%. The latter change increases the valuation multiple applied to terminal year earnings from 13 times to 19 times. Risks to our price target being reached are spelled out on the risks and catalysts section on the first page of this report.

Figure 4: Discounted cash flow valuation

Year ended 30 June	2020	2021	2022	2023	2024
A$m					
EBIT	0	8	16	27	40
D&A	*10*	*11*	*12*	*13*	*14*
Ebitda	10	18	28	40	54
Capex	-11	-12	-14	-15	-16
WC Change	2	1	1	1	1
Interest	0	0	1	1	1
Tax	0	0	0	0	-8
Free Cash Flow	1	7	16	27	31
Other adjustments	-	-	-	-	-
Free Cash Flow	1	7	16	27	31
Discount Factor	1.00	0.87	0.75	0.65	0.57
NPV of Free Cash Flow	1.0	6.2	11.8	17.4	17.6
NPV of Terminal Value					339
NPV					401
Cash/other					20
Total Present Value					421
FD Shares Out (FD)					278
NPV/Share					1.51

Modelling Assumptions	
Risk Free Rate	6.0%
Equity Risk Premium	6.0%
Company Beta	1.10
Cost of Equity	13.2%
Debt %	0%
Cost of Debt	5.5%
Tax Rate	30%
WACC	13.2%
Long Term growth rate	8.0%
Implied TV Multiple	19
Discounted Terminal Value	339
NPV $	401

SOURCES: MORGANS ESTIMATES

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 prove cash flow self-sufficiency in FY20. Due to the substantial increase in our revised share price target, we upgrade our investment recommendation to HOLD (was REDUCE).

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