RBL – Trading update.

A crossroads

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Chapter 1 – Breaking down the letter to shareholders.

I joined Redbubble Group after having been a customer on the platform and believing there is something special about this organisation. After three months my enthusiasm for the opportunity has continued to grow and I am more excited than ever in the tremendous potential the Redbubble Group has. Our mission - **"To create the world's largest marketplace for independent artists"** - really does sit at the centre of what we do and reflects the broad ambition for the Group.

Consumer preferences, and the ecommerce landscape, continue to change across the globe. By offering consumers an absolutely unique content and product offering within a compelling shopping experience, Redbubble is positioned to become one of the global winners in this evolving landscape. Consumers are less interested in wearing the same commodity black t-shirt owned by millions of others, instead they look for meaning and uniqueness in what they buy. They want a t-shirt, or phone case, or poster with a design that expresses their individuality, personality and passions. Redbubble is far and away the best

Here Michael is outlining what he desires RBL to become – a hub for everything unique and customised (instead of commoditised branding in shopping).

Whether one is bullish, or bearish on RBL in general there are a few arguments made (& I have hypothesized below)

Typical Bull thesis – **shopping experiences and consumer trends are changing.** Customisation and shopping online is becoming a lot more preferable to that of the past. Yes, understandably COVID has changed the consumer landscape, but **the trend is here to stay**. Now that people have had a taste of what its like to shop online, they prefer to do that moving forward.

Typical bear thesis,– "Ah yes mask sales can't be sustained and the growth that RBL experienced over the past 12 months was because everyone was stuck at home **isn't going to last**. Everyone that shopped online over the past 12 months will go back to doing so in person".

There are some truths in both, but below are a bunch of **facts** that contradict both arguments in some sense.

- The **majority of RBL sales come from America**, whereby lockdowns have been inconsistent over the last 12 months.
- Lockdowns in many US states were inconsistent, some shops remained open.
- Masks as a % of sales has come down from a high of ~13%.
- COVID & lockdowns in general are "phasing out" due to the vaccine rollout (particularly in the US & UK markets).

Region	% total business
ROW	1%
AU/NZ	6%
UK	11%
EU	14%
North America	69%

Michael Ilcyznski (CEO) is obviously of the belief that the consumer changes that were forced by the covid lockdowns will somewhat be affected in the long run. Otherwise what successful business person/investor would step into the role of RBL CEO, **take a $2m stake in the company** and then plan to double revenue over the next 3 years.

How does he plan to do this;

- **CY21: Focus on four strategic themes to build the foundations for further growth**
  The previously shared key strategic themes remain the right areas of focus to strengthen the foundations of the business, building our internal capabilities to enable us to grow in the periods ahead. These key themes remain:
  - Artist activation and retention
  - Customer understanding, loyalty and brand development
  - User acquisition and transaction optimization
  - Physical Product Range and 3rd Party fulfillment network scaling

Spending $

- **CY22-24: Grow top-line sales through disciplined investment**
  The increased internal capabilities will enable us to undertake disciplined investment to increase both customer acquisition and loyalty. There will be some investment into people (OPEX), as well as targeted investments in Gross Margin and Marketing. There are multiple levers for growth we will pursue, including:
  - Enhancing the core customer experience
    - Improved digital experience and physical product quality
    - Growing loyalty and repeat purchasing
  - Continuing to earn growth in core markets
    - Consistent and selective addition of new physical products
    - Improvement to the 3rd party fulfillment and logistics network
  - Amplifying growth by increasing customers
    - Brand investment to increase awareness and trial
    - Expansion into new geographic markets

Spend $.

To translate the above in my honest opinion;

Michael understands that **RBL is at a crossroads** when it comes to capturing the massively increased total addressable market (TAM). To become a global leader in this space, **RBL (& their shareholders) must be willing to sacrifice some short term profits/free cash flows** by investing heavily in marketing & customer acquisition.

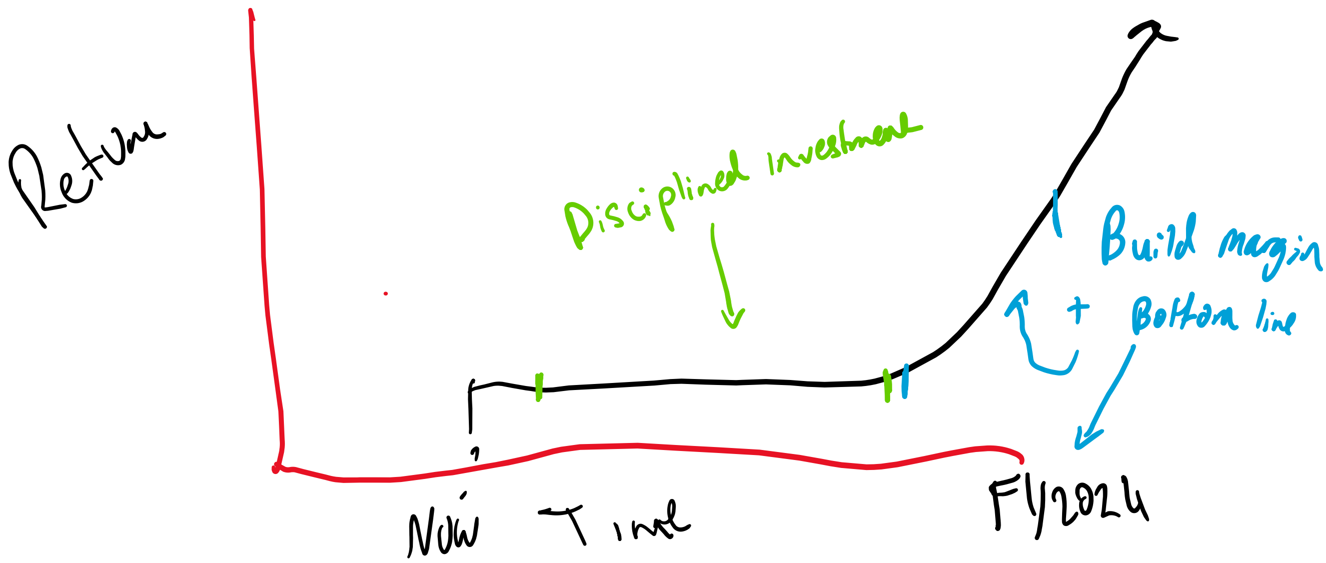
I believe in the coming 6-12 months, Michael will be taking a hammer to the Profit & loss statement. “Disciplined investment” = spending a shit load of money so that the customer base is much much wider in 2024.

i.e Make profit $

- **CY24+: Build margin and bottom line as we scale and grow from this investment**
  As sales and revenues grow, we will look to accelerate the operating leverage once again and see corresponding growth in cashflows and EBITDA. We believe the margin profile below is achievable at a scale of $1.25 billion+ Marketplace Revenue as investments in Brand and OPEX are offset by scale economies across the supply chain and efficiencies internally

By 2024, the disciplined investment into the companies marketing and revenue growth capabilities will begin to shine through. The RBL will hopefully be the leader in the global ecommerce space and thus the operating leverage Michael hoped for will be delivered to shareholders.

I think what this effectively means for shareholders is that the next 18-24 months will see a lot of relatively flat, or downward pressure on profits/cashflows and thusly returns. The reward that one will experience from an investment today **<u>will NOT be in a linear fashion</u>**, more like below.



What I like a lot about all of this – Michael is able to quantify some objectives for RBL by FY2024.

Margin Aspiration at $1.25 billion+ MPR

- 40-42% Gross Margins
- 12-15% Marketing (Paid Acquisition and Brand)
- 15% OPEX (Operating Expenses)
- 10-15% EBITDA

10-15% EBITDA margin is a wide margin. 10% would make the investment a sell, where 15% would make RBL a screaming buy. My quantified analysis is as follows;

Chapter 2 – Outcomes from the aspirations set by the CEO.

#outcome 1 – Low conviction and bottom of the range aspirations

(Here I taken the above aspirations at the bottom of the range.)

Scenario #1 - "low conviction"	
Assumptions	
Revenue	1250
Gross Margin	39%
EBITDA Margin	9%
Tax rate	27.50%
SO	264
Cash at FY24	300

The P&L statement would look roughly like below

	FY24
Market place revenue	**1250.0**
Artist revenue	0.0
Total Revenue	**1250.0**
Change - sequential	
Change - pcp	
Fulfiller expenses	-762.5
Artist margin	0.0
Total COGS	
Gross profit	487.5
GP Margin	0.4
Other income	0.0
Operating expenses	
Acquisition costs	
Employee costs	
Marketing (as different from acquisitic	
Operations & admin	
Share based payments	
TeePublic acquisition costs (one off ite	
"other" costs	
Total operating expenses	-375.0
Change in cost base %	
EBITDA	112.5
Dep & Amort	-15.0
EBIT	97.5
Net interest	0.0
PBT	97.5
Tax Expense	-26.8
NPAT	70.7

Then comes – "What will the market value this at in 2024, keeping in mind that it has *barely* hit the targets set in FY21"

Below is a range of outcomes, based on a share price of **approximately $4.20** and no new share issues.;

Then we apply a variety of "exit price" Ev/EBITDA valuations				
	(EV/EBIT MULTIPLE APPLIED)			
	10	***12***	***14***	***17***
EV/EBITDA	825	1050	1275	1612.5
EV/EBIT	675	870	1065	1357.5
P/E	15.92	19.10	22.28	27.06
implied sp	4.26	5.11	5.97	7.24
implied CAIR	0%	7%	12%	20%

(I.e if we believe the business will be valued at a EV/EBITDA of 10 times, it will price a compounded annualised investment return in FY24 of 0%, and give the business a P/E of 16 x).

So in short, given that outcome #1 occurs, the business would have to command a 17x EV/EBITDA to make the investment attractive at the current price.

I would never investment in RBL, needing a stretched valuation of 17x to give me a decent return of 20% CAIR.

#outcome 2 – Medium conviction

(Here I have taken a midpoint of the aspirations set by the CEO)

Scenario #2 - "medium convictio	
Assumptions	
Revenue	1250
Gross Margin	42.50%
EBITDA Margin	12.50%
Tax rate	27.50%
SO	264
Cash at FY24	300

Margin Aspiration at $1.25 billion+ MPR

- 40-42% Gross Margins
- 12-15% Marketing (Paid Acquisition and Brand)
- 15% OPEX (Operating Expenses)
- 10-15% EBITDA

The P&L would look roughly as follows;

	FY24
Market place revenue	1250
Artist revenue	0
Total Revenue	1250
Change - sequential	
Change - pcp	
Fulfiller expenses	
Artist margin	
Total COGS	-731.25
Gross profit	518.75
GP Margin	41.50%
Other income	0
Operating expenses	
Acquisition costs	
Employee costs	
Marketing (as different from acquisitic	
Operations & admin	
Share based payments	
TeePublic acquisition costs (one off ite	
"other" costs	
Total operating expenses	-362.5
Change in cost base %	
EBITDA	156.25
Dep & Amort	-15
EBIT	141.25
Net interest	0
PBT	141.25
Tax Expense	-38.8
NPAT	102.4
Change - sequential	
Change pcp	

If they can achieve the midpoint of the results, the outcomes are a lot more positive.

	(EV/EBIT MULTIPLE APPLIED)			
	10	**12**	**14**	**17**
EV/EBITDA	1262.5	1575	1887.5	2356.25
EV/EBIT	1112.5	1395	1677.5	2101.25
P/E	15.3	18.3	21.4	25.9
Implied SP	5.92	7.10	8.29	10.06
Implied CAIR	12%	19%	25%	34%

I would only need a EV/EBITDA multiple of 14x to make an affective 25% CAIR. I think 14x is a reasonable multiple to pay for a business that is rather capital light and FCF generating.

#outcome 3 – High conviction

Scenario #3 - "High conviction	
Assumptions;	
Revenue	1250
Gross Margin	42%
EBITDA Margin	15%
Tax rate	27.50%
SO	264
Cash at FY24	350

Margin Aspiration at $1.25 billion+ MPR

- 40-42% Gross Margins
- 12-15% Marketing (Paid Acquisition and Brand)
- 15% OPEX (Operating Expenses)
- 10-15% EBITDA

The P&L would roughly look as follows;

	FY24
Market place revenue	0.0
Artist revenue	1250.0
Total Revenue	
Change - sequential	
Change - pcp	
Fulfiller expenses	-725.0
Artist margin	0.0
Total COGS	-725.0
Gross profit	525.0
GP Margin	42%
Other income	0.0
Operating expenses	
Acquisition costs	
Employee costs	
Marketing (as different from acquisitic	
Operations & admin	
Share based payments	
TeePublic acquisition costs (one off ite	
"other" costs	
Total operating expenses	-337.5
Change in cost base %	
EBITDA	187.5
Dep & Amort	-15.0
EBIT	172.5
Net interest	0.0
PBT	172.5
Tax Expense	-47.4
NPAT	125.1

And the results are a lot more attractive when it comes to valuation.

	(EV/EBIT MULTIPLE APPLIED)			
	10	**12**	**14**	**17**
EV/EBITDA	1525	1900	2275	2837.5
EV/EBIT	1375	1720	2065	2582.5
P/E	15.0	18.0	21.0	25.5
Implied SP	7.10	8.52	9.94	12.07
Implied CAIR	20%	28%	35%	44%

So if; I believe the company can achieve an EBITDA margin of 15% on 1.25bn, I would buy today regardless of what the market valuation in 2024 would be (see all green outcomes). My CAIR would be atleast 20%.

If the company were able to achieve the targets in outcome 3, the **market multiple applied in 2024, is likely to be 14 x EV/EBITDA +,** making the return per annum 35% +.

For the sake of simplicity, I have highlighted in RED where I believe the investment outcomes represents a sell and green where I believe it represents a BUY. (or uncoloured where I think it's a hold).

Chapter 3 – Taking a probability weighted average for IV

$$\bar{x} = \frac{\sum w_i x_i}{\sum w_i}$$

Just to clarify, I have used the above formula in calculating an IV. Steps are listed below;

Step 1 – Come up with valuations under different outcomes (bullish, bearish & medium case)

Step 2 – Apply different probability weightings to each outcome

Step 3 – Multiply the output * the probability applied and sum them all.

Below are the weightings I have applied to each outcome.

Outcome #1 – Low conviction

Scenario #1 - "low conviction"		Then we apply a variety of "exit price" Ev/EBITDA valuations					
Assumptions			*(EV/EBIT MULTIPLE APPLIED)*				
			10	***12***	***14***	***17***	
Revenue	1250	EV/EBITDA	825	1050	1275	1612.5	
Gross Margin	39%	EV/EBIT	675	870	1065	1357.5	
EBITDA Margin	**9%**	P/E	15.92	19.10	22.28	27.06	
Tax rate	27.50%						
SO	264	**implied sp**	4.26	5.11	5.97	7.24	
Cash at FY24	300	**implied CAIR**	0%	7%	12%	20%	
FY24							*cumulative prob*
		Probability applied	5%	11%	8%	3%	27%

i.e – the stock if performing poorly will likely demand a lower a multiple. A higher probability has hence been applied to a 12x EV/EBITDA multiple.

Outcome #2 – Medium conviction

Scenario #2 - "medium co							
Assumptions			*(EV/EBIT MULTIPLE APPLIED)*				
			10	**12**	**14**	**17**	
Revenue	1250	EV/EBITDA	1262.5	1575	1887.5	2356.25	
Gross Margin	41.50%	EV/EBIT	1112.5	1395	1677.5	2101.25	
EBITDA Margin	**12.50%**	P/E	15.3	18.3	21.4	25.9	
Tax rate	27.50%						
SO	264	**Implied SP**	5.92	7.10	8.29	10.06	
Cash at FY24	300	**Implied CAIR**	12%	19%	25%	34%	
FY24							*cumulative prob*
		Probability applied	4%	10%	10%	7%	58.00%

Outcome #3 – High conviction

Scenario #3 - "High conviction							
Assumptions;			(EV/EBIT MULTIPLE APPLIED)				
			10	12	14	17	
Revenue	1250	EV/EBITDA	1525	1900	2275	2837.5	
Gross Margin	42%	EV/EBIT	1375	1720	2065	2582.5	
EBITDA Margin	**15%**	P/E	15.0	18.0	21.0	25.5	
Tax rate	27.50%						
SO	264	**Implied SP**	7.10	8.52	9.94	12.07	
Cash at FY24	350	**Implied CAIR**	20%	28%	35%	44%	
FY24							*cumulative prob*
1250.0		Probability applied	2%	11%	13%	9%	93.00%

(i.e if the stock pulls through at a 15% EBITDA margin, the market will more likely value it on a multiple of 14x +)

Outcomes #4&5 – Severe out/under performance

2% chance the stock severly outperforms (ends up at $10)
5% chance the stock severely underperforms (ends up at $2.00)

Output - IV

Todays price to todays value.

Valuation - weighted probability of outcomes	
2024 IV	7.71
Today's IV	5.79
Discount of P/V	38%
CAIR (3 years)	22%
(todays price)	4.2

Compounded investment return

Chapter 4 – What happens in the short to medium term?

In short, I wouldn't be surprised to see the stock under pressure. To quantify this to those who base everything off numbers (usually myself) a 30% decline from the time of writing price, $4.20, leaves the stock around $3. Unless the sales numbers are impressive for the JH (weaker half), I wouldn't expect to see too much genuine upside*.

(*When I say genuine upside I mean value creation because who knows in todays market)

One may reasonably ask – "*If you think the stock will go down in the short term, then why would you want to buy or hold in the mean time?*"

For me I think its depends on a few of the following factors in which I have made elaborating points;

- Investment style/philosophy
  - Those that have a "bottom drawer" approach to stocks in which they hold may just to happy to pay now and see the gains in the future
- A lack of other attractive opportunities
  - I mean you don't want to just hold cash, right?
- **Not trying to time '*the bottom*'**
  - If the stock falls and the valuation & thesis remain attractive, then it just makes sense to buy more stock. Trying to guess when this is on a timeline is a fools game.

Conclusion

Its going to take a lot of execution and operational expertise from the management team to steer RBL towards its 2024 objectives.

In saying that, the CEO knows the company better than myself or any other shareholder for that matter. It wouldn't be wise to bet against what he knows versus what you think you know.

Although Michael has only been at the helm for 5 months, he has a vested interest in the company and a great resume to boot.

Perhaps a classic tale of under-promise and over deliver? Only time will tell.