TOLLYMORE

INVESTMENT PARTNERS

A letter to partners, September 2021

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INVESTMENT PARTNERS

Dear partners,

Tollymore generated returns of +9% in the first nine months of 2021, net of all fees and expenses. Investment results since inception are shown below[1]:

USD	Tollymore (gross)	Tollymore (net)	MSCI ACWI
2016	17%	15%	8%
2017	25%	22%	24%
2018	(2%)	(3%)	(10%)
2019	21%	20%	26%
2020	92%	81%	16%
2021 YTD	10%	9%	11%
Cumulative	264%	220%	97%
Annualised	27%	24%	13%

Value chain symbiosis vs. other business quality frameworks

Adversarial vs. cooperative value chains

We seek "non-zero-sumness", or symbiotic value chains, in the small collection of companies we own. A symbiotic value chain is one in which multiple stakeholders participate in a company's value creation; success is shared with customers, employees and owners through thoughtful and transparent incentives. When the mission goes beyond profit maximisation, profit maximisation is often the result. When all stakeholders are inspired by a mission, short term sacrifices in the interests of long-term outcomes become easier. This makes for a more defensible, less replicable business as stakeholders adhere to the mission through good times and bad. Value chain symbiosis (VCS) cannot be achieved while one component's profits are another component's losses.

We are value investors. But rather than seeking value in weak companies, we are trying to find it in strong companies. We define business strength here in terms of durable corporate vitality; the possibility for a company and its constituent parts to flourish for a long time.

Through this lens, conventional business quality frameworks such as Porter's Five Forces seem somewhat unstable. Concepts such as supplier and buyer bargaining power imply a non-zero-sum value chain, whereas VCS has at its heart the idea of win-win-win. Rather than investing in

[1] Portfolio inception 12 May 2016. Managed account results are reported until 30 June 2021, after which results of Tollymore Segregated Portfolio Share Class A are reported. Results of MSCI All Country World Index (ACWI) are total return including dividends. Results are presented in USD, unaudited, net of all expenses, 1% management fee and 10% incentive fee in excess of a 6% compounding hurdle.

the customer and supplier proposition, Porter's forces connote an adversarial relationship between the company and its vendors and consumers.

And the first of the five, competitive rivalry[2], has left most corporate leaders to obsess over competitors at the expense of delighting customers. The popular adoption of military texts by business executives is the result of, or perhaps driven by, an intense focus on existing competitors[3].

Game theory, or the economics of strategic behaviour, has little to say about value creation for value chain constituents. Here too, there is an overwhelming focus on competitive behaviour and incentives. The internet has lowered the barriers to entry across many industries. Incumbent businesses compete with many challengers, often across the globe, lowering the practical use of academic theories of competitive behaviour that assume a handful of rivals can be observed.

Time arbitrage may be our only opportunity for great investment results. So, frameworks for appraising corporate vitality should be more deep-rooted and durable. Thinking about these types of business characteristics may help us to identify and recognise patterns of successful behaviour[4]. But I do not wish to use them in a prescriptive way. To do so may restrict our investment universe, in so doing lowering our hurdle for portfolio inclusion. The goal here is not to find the best mental model, or the mental model that will unlock superior investment results. Models will come and go. They will be relevant and then irrelevant. One hack that might help us to find mispriced insights is to think from first principles. For example, I think that it is hard to conclude, from first principles, that businesses which suppress competition with switching costs or patents, have a moat over a *very* long period. This is because these situations lead to disgruntled value chains. The goal of customer happiness may be consistent with VCS; the goal of customer captivity is unlikely to be. Disgruntled value chains are a symptom of egregious and ephemeral profit extraction and invite business model disruption[5].

Dominance acquired via customer captivity may last a long time. In the case of Gillette, it took about a century before Dollar Shave Club offered a pay-as-you-go, cancel anytime razer supply without the razor-and-blade pricing model[6] that has been the subject of much acclaim. In the thirty or so years prior to Dollar Shave Club, Gillette had around two thousand patents granted. Patents that were used to protect evermore incremental tweaks to its product. That is a lot of effort and capital directed at stifling competition rather than delighting customers. Even when business dominance acquired via these means lasts a long time, it can unravel quickly when a new proposition reveals the customer preferences that were not being met. I suspect that the speed of Gillette's market share reversal was not just down to DSC's viral commercials, but also the pent-up frustration from a customer base that felt overcharged and underserved. Goodwill

[2] And, more subtly, the threat of new entrants and substitutes.
[3] https://www.business2community.com/strategy/sun-tzu-and-the-art-of-business-strategy-0587525
[4] Incidentally I think the ability to identify and apply generalisable patterns is a strong case for generalist investing.
[5] Large and fast changes in market shares.
[6] Other examples: Kodak cameras, HP printers, Nespresso coffee machines.

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and reputation are destroyed faster than they are built and going against customers' needs should not be considered a reliably durable business strategy.

VCS and disruptive innovation

Today disruptors are not typically seeking to replace incumbents entirely. Rather, they break the links in the customer journey, in doing so better aligning monetisation with value creation and minimising externalities. For example, Amazon broke the link between product browsing and purchasing, Zipcar broke the link between car purchasing and driving, Uber broke the link between hailing a taxi and riding in one, Blue Apron broke the link between ingredient shopping and meal preparation, Airbnb broke the link between staying in residential property and owning it.

Zipcar, Uber and Airbnb are specific examples of business model innovation which separated asset use from ownership. This is hardly a novel idea; it's called renting. Rental models lend themselves to assets which are expensive and durable, and where usage is infrequent. Amerco did this with trucks, and gyms have been doing it for thousands of years.

Of course, business and investment frameworks need not compete with one another. In business ownership there are multiple ways to create value. Our ownership of low-cost gyms is an expression of mispriced business model innovation first proposed by Clayton Christensen. That is, incumbents' neglect of less profitable customers creates an opportunity for challengers to enter at the lower end of the market. Mid-tier gyms, focused on preserving existing profitability, initially disregarded the growing traction of low-cost gyms. Despite this low-cost challenger playbook in airlines and supermarkets resulting in large mid-tier market share loss, mid-tier gyms ignored low-cost traction for the best part of a decade. The low-cost model increasingly appeals to mainstream members due to increasing scale benefits being shared with the value chain. I expect gym members to continue to migrate to these disruptive low-cost gyms; the incumbents have nowhere to go, given the large price and profit differences vs. the low-cost alternatives. Adopting the same business model would harm the incumbent's existing business by requiring a capital-intensive reengineering of their entire estate[7].

Christensen's frameworks are 25 years old. And there is plenty of evidence of this type of business model disruption across industries. And yet it reliably continues to happen. Around the same time as the Innovator's Dilemma was published, Netflix launched its DVD-by-mail business. One of the cornerstones of Netflix's proposition was a promise not to charge late fees. The incumbent, Blockbuster generated 16% of its revenue from this highly lucrative activity. With slender operating margins, like mid-tier gyms, Blockbuster had nowhere to go. Hamilton Helmer has referred to this as 'counter-positioning'. Counter-positioning occurs when the NPV challenger strategy is positive for the challenger but negative for the incumbent. Counter-

[7] Incumbents have made perfunctory and unsuccessful efforts to do so.

positioning, rather than managerial incompetence or technological inferiority[8], is responsible for Blockbuster taking seven years to launch a DVD-by-mail business. Adopting the challenger model becomes rational when the incumbent's core business has shrunk enough to make this a value accretive activity.

Often the incumbent's response to being disrupted is to attempt to reclaim customer captivity and therefore move even further away from VCS. A more sustainable approach is to identify the incumbent's value creating activities and monetise those – the slotting fees of supermarkets and consumer electronics chains are one example of this, in which manufacturers are charged for product placement.

Next plc. (NXT.LN): a model for incumbent response

A focus on VCS will allow incumbents to successfully disrupt and defend against disruption. Special managerial foresight, including an appreciation of VCS, a willingness and ability to self-disrupt, and good luck, are required to successfully defend incumbent business models. Next plc., skilfully stewarded by Simon Wolfson, ticks all these boxes. Since 2014 Next has featured third party brands alongside its own brands through its online platform LABEL. This has been a profitable strategy for Next. So why have ecommerce challengers not counter-positioned this brick-and-mortar incumbent? It has been fortunate to own assets which are crucial to consumers' omnichannel shopping preferences. These include its stores which serve as convenient pick up and return points, and its logistics infrastructure which is a legacy from the catalogue business it launched 35 years ago. Lord Wolfson recognised the opportunity to repurpose these assets in a more digital world. Next's online investments over the last 20 years are evidence of customer-centricity. But its more recent efforts to help competing brands increase their addressable markets demonstrate VCS by treating both customers and suppliers as clients, as partners. Today online is 70% of Next's business[9]. A counter-positioned incumbent may have arrived at this point due to core business erosion. But Next got here by profitably growing online sales. By accepting the near-term cannibalisation of the traditional business in return for becoming the operating system of multichannel ecommerce.

While the retail drag continues to diminish, online opportunities have materially increased, and online customer growth is accelerating. This traction is galvanising management's ambitions for LABEL, in a manner consistent with VCS: *"We recognise LABEL can only be successful if it treats brands as valued clients rather than "suppliers".* With greater numbers of engaged customers, Next can more easily uphold its promise of being the most profitable route to market[10].

[8] Technological disruption occurs when the incumbent lacks the expertise necessary to be successful in the challenger's business model. E.g., Kodak succumbed to digital photography challengers because it lacked semiconductor memory expertise.
[9] Next is a business in transition and may be considered at somewhat of a tipping point; today as many people are employed in technology as buying/merchandise.
[10] In August NXT lowered the commission rate on clothing for the third time in three years. Scale economies are being shared with the entire value chain, not just customers.

Under 'Total Platform' Next makes its warehouses, call centres, distribution networks, customer relationships, marketing engine and lending business available to third party brands, including next day delivery services and store collections and returns. Next also builds and operates brand.com, all in return for a 39% commission on brand partner sales. By creating substantial value for brand partners, customer delight is achieved through better value products.

Next's recent results demonstrated further progress in becoming the operating system of multi-brand omnichannel retail. Next is becoming increasingly embedded in the value chains of its brand partners; it is becoming the value chain within a value chain. Next is taking on more functions of brand partners' business models, allowing brands to de-risk their businesses and focus on what they enjoy: design. Increasingly Next is manufacturing partner brands' products under licence[11], further integrating itself into retail value chains by connecting merchants with manufacturers. This is one less thing for the brand to worry about, and a relatively straightforward activity for Next to leverage its sourcing experience to create and distribute brands' products.

For the first time, Next collaborated with LABEL brands to co-fund digital advertising campaigns for third party brands on Next's website. The company intends to aggressively extend this programme to increase awareness of LABEL. This is another example of cooperative rather than adversarial value chain behaviour. This cooperative behaviour is valuable for owners too. Returns on digital marketing efforts are increasing, and this year the company will spend nothing on catalogue production for the first time in 30 years. For every £1 Next has spent this year, it has already generated £1 of profit. And this is before the positive impact of greater partnership advertising.

So, LABEL unit economics are attractive. But LABEL's success also improves the working capital efficiency of the business. This is because with greater SKU variety, close substitutes can be found for out-of-stock items, requiring less inventory cover.

LABEL added 320 new brands over the last two years with 60% of sales now generated via commissions vs. wholesale. Next's strong business progress contrasts with a UK High Street in disarray. When stores reopened LABEL sales did not suffer, suggesting limited high street competition for the LABEL business.

[11] Next now manufactures stock under licence with 12 partners, including Childsplay, Laura Ashley, Victoria's Secret, Aubin, Reiss and GAP

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Business model innovation case studies: shrinking supply chains

Shrinking supply chains, or disintermediation, are consistent with both this idea of customer-driven disruption, and value chain symbiosis.

Consider meal kit delivery business models such as **HelloFresh (HFG.DE)**. The supply chain *pulls demand from the consumer*. Orders are only fulfilled when the customer places their order, vs. a traditional supply chain in which products are pushed from the producer. In the shortened supply chain products are distributed direct to home, vs. the traditional model in which there are multiple components such as wholesalers, warehousing and stores with whom value add must be shared. Shortened supply chains are faster – typically a few days from order to delivery. Because there are fewer steps, there is typically less waste and more margin, so they have the capacity to be better for the environment[12] and owners as well as suppliers and consumers. Management also seems to understand VCS and intends to share HFG's growing scale and better margins into product and service improvements.

HFG is a mission-oriented business[13], which makes VCS more possible. HFG is disrupting its existing market with business model rather than technological innovation. A potentially key insight is there is only one brand (HelloFresh) which minimises economic leakage associated with multiple brands and marketing dollars. A less complex value chain consists of the producer and HFG only, in one vertically integrated model. There is much to like vs. the standard ecommerce model which simply moves existing supply chains online: order frequency is high and predictable, and working capital is negative, leading to attractive cash generation.

To my mind the customer proposition is extremely compelling: this is one of the very few business models that is both highly convenient and highly affordable vs. the incumbent offering. This is certainly the case when the incumbent offering is supermarket grocery shopping. But it is arguably also true against grocery delivery, restaurants and food delivery. These alternatives take more time and/or are more expensive than meal kit delivery.

Online food is decades behind other established ecommerce categories and COVID may have allowed consumers enough time to better understand the options available to buy food online, and to form lasting shopping habits. And HFG has audacious ambitions to disrupt the grocery supply chain, one of the largest industries in the world.

I did not add HFG to Tollymore's collection of businesses. As a customer of Gousto, an HFG rival, I think this is the future of food consumption. Value is undeniably being created via business model innovation.

[12] Meal kit delivery supply chain CO_2 emissions are 85% lower than supermarkets as there is no need to heat, light and cool thousands of stores. One third of the world's food production never reaches us and food production is responsible for one quarter of greenhouse gas emissions. HFG's food waste per € of revenue is 70% lower than supermarkets.
[13] To change the way people eat forever; to be the world's leading fully integrated food solutions group.

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But while this is a membership model, the offering is somewhat commoditised, and switching is prevented largely by inertia. The recurring revenue nature of the business restricts customer's ability to shop around at the point of sale, as they are free to do with food delivery and ride hailing for example. Customer churn has improved but is still very high. This may be down to competitor promotions, which may elevate the cost of customer acquisition and cap achievable long-term profitability (as may the replicability of the assets).

This is a better value, more convenient and more sustainable alternative to supermarket grocery shopping. But in the absence of barriers to profitable participation, my sense is that most of this value will accrue to the consumer. In the absence of a moat, it ultimately fails the VCS test. The moat may be down to execution, which matters a lot. But it is harder to underwrite and there was no shortage of VC dollars backing Blue Apron not so long ago.

One business that is disrupting existing markets via business model innovation with assets that are very hard to replicate, and in a manner consistent with VCS, is **Redbubble (RBL.AX)**. I have been buying shares in RBL over the last year at an average price of AUD 4.40.

RBL is a three-sided marketplace connecting 700k independent artists, almost 10mn customers and a third-party network of 44 global fulfilment partners. The business was founded in 2006 as a social network for artists, but today is a platform centred around artists, onto which they can upload their artwork which can then be printed onto a wide variety of merchandise such as t-shirts, phone covers and scatter cushions. RBL caters to consumers and artists who value individuality and find mass-production unappealing ('anti-Amazon'). Products are made on demand (POD) by third party fulfillers, who print designs onto standard 'blanks' (the white label product e.g., hat, skirt, coaster) and ship the product directly to the consumer.

RBL is a leader in a new business model: on-demand retail. RBL is neither 1P nor 3P; POD is a different business model that shortens the supply chain by creating and distributing inventory only when the order is placed. This business model innovation seems to be occurring due to changes in customer demand along the vectors of product uniqueness, variety, quality and choice, delivery experience, and sustainability.

As products are manufactured and shipped on demand, RBL benefits from negative working capital and cash inflows due to growing revenues. Customers pay upfront, while fulfillers and artists are paid after shipment. This is a cost of growth advantage that may be missed by investors preoccupied with profit margins. Zara, considered one of the world's most efficient and capable fashion retailers with a best in class supply chain, takes 60-90 days to complete a working capital cycle; RBL's is less than a week.

Often marketplaces are difficult environments to sustain VCS because sellers can view them as necessary evils. Changing incentives are responsible for this. For example, to build liquidity and scale a marketplace may offer very low take rates and advertising fees. One part of the value chain, in this case sellers, may become more reliant on the platform to access customers, in the process diluting its direct relationship with them. As power increasingly shifts to the platform

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the temptation to exploit this grows. But long-term platform operators understand that whilst moves to exploit suppliers, customers or employees may result in ephemeral economic extraction, they open the whole ecosystem to business model innovation and disruption seeking to solve a problem for the disgruntled part of the value chain.

Fragmented, global supply is one reason that sellers may not wish to secure direct customer relationships. A local Chinese restaurant or plumber may find initial value in partnering with Just Eat or Checkatrade.com, but they become incentivised to disintermediate the platform and nurture local relationships with their customers directly.

Another reason is that the vendor proposition is highly compelling even as the marketplace grows and the balance of power shifts. Marketplace owners that seek to equitably share the fruits of operating leverage with value chain components are likely to be more defensible. Again, switching costs cannot support truly sustainable excess profit creation.

RBL benefits from a fragmented, global artist community and a management team sympathetic to the idea that sharing a larger pie in a way that delights all value chain constituents makes for a very hard to replicate business. There is an obvious short-term incentive to monetise sellers by charging them advertising fees for better discovery. Deeper pockets, rather than superior products, drive success. This is not what customers, nor (talented and hardworking) sellers, want and is therefore potentially an impediment to VCS. There will be a point when this urge will become hard to resist. But for now, the organic nature of content discovery is an important competitive differentiator and facilitator of win-win-win.

A key difference is that RBL is centred on the artist before the customer. Some feedback from a seller which highlights some of the implications of this for value chain symbiosis:

"Redbubble (and Zazzle, one of their competitors) for example don't manipulate the visibility of the seller's listings like Amazon and Etsy do. Amazon and Etsy force their sellers to pay expensive ads to get visibility for their products. The harder the competition gets on these two platforms, the higher the marketing costs for the sellers rise. Additionally, Etsy significantly increased the fees over the years, and they try to force their sellers to ship their products for free to the customers. If you don't ship for free the visibility of your products gets reduced. Etsy and Amazon earn tons of money selling prominent product listing places to sellers. So, you have high marketing costs on their platforms, or your products nearly don't get seen by customers. Much pressure. On Redbubble and Zazzle all listings show up organically. So, the most liked or the best products automatically show up on the top and not the products for which the highest marketing fees were paid (and that are often not what the customers are looking for). It's easy for a seller to get in friendly contact with Redbubble when there is a problem - quite different from the anonymous and uncaring companies Amazon and Etsy, who mostly only send you prefabricated, delayed standard texts. On Amazon and Etsy, you often get your designs stolen and copied and both companies don't care about that, or it takes a long time until they react. In contrast Redbubble cares. Quite a few sellers now who left Amazon and Etsy and only sell on Redbubble. I wish this sympathetic company much success".

RBL receives a 30% take rate of the GMV in return for connecting the artist, consumer and fulfiller. For every $100 of products sold, the artist makes $15, the fulfiller $44, the payment platform $3 and the tax man $8, leaving $30 for RBL. This is a high take rate by the standards of modern marketplaces[14]. The high take rate is justified by high GMV growth and greater scale enabling lower per unit fulfilment costs.

Artists are not making huge sums from their participation on RBL. Yet their numbers are growing strongly. In addition to a low-risk way to earn extra income, artists are seeking validation of their talents and efforts. This search for recognition is a non-monetary stakeholder incentive that may make non-zero-sumness easier to achieve and sustain. Similarly, the creative nature of this industry and of the people involved – from programmers to business development personnel – may lend itself to mission-orientation and VCS. High revenue per employee of almost AUD 2mn is perhaps testament to the idea that financial incentives are insufficient to bring out the best in people. Management understands the need to keep various stakeholders happy, demonstrated by the priorities for measuring success:

"The metrics by which we will measure our success are firstly Gross Transaction Value, Artist Revenue and Marketplace Revenue"

Management's forward projections imply that artists will receive the same percentage of GMV as they do today (c.15%) despite the larger scale of the business[15]. They will be receiving more value for the same price. Management seems to understand the value of delighting multiple parts of the value chain. Even as they dedicate more focus to consumers, they are doing so by making the artist's life easier:

"Focusing on the consumer is not about not focusing on the artist. It's actually about focusing on the core thing that the artists want from the platform, which is to sell products featuring their designs. Yes, we're trying to get some balance into the way that we focus, to really focus on all aspects of that consumer journey…The beauty of marketplaces is that you must be an 'and' business; you must be both. It can't be artists or consumers; it must be both. Great marketplaces know how to balance the needs of both sides of the marketplace, think about both simultaneously and hold two competing ideas. On one side, I must think about it as an artist services platform and, on the other side, I must think about consumers and all the different places they could go to shop that have nothing to do with independent artists; it's just, where do they buy a cool hat. That's the challenge and that's what makes these marketplaces fun. It's what makes them unique when they work and it's also what makes them hard to replicate. They're not easy businesses."

[14] Like our other marketplace holding companies Next (39%) and Farfetch (30%).
[15] Artist margin has not scaled over time – it was c.15% in 2015, it is the same today and is expected to be the same in the future. Trupanion is another business Tollymore owns that has enshrined its customer value promise in a formula.

RBL allows artists to focus on being creative; creating artwork without having to consider how to market and distribute it[16]. Artists have the autonomy to set their margin and can choose which of RBL's 120 products onto which their designs are printed. Artists benefit from RBL's collective marketing dollars and demand generation engine. Finally, RBL arranges the manufacture and shipping of these products.

RBL management refers to a desire to be artists' first choice (onboarding is easy, low cost and low risk), and best choice (return on effort is better with RBL than any other monetisation method, such as Shopify or connecting with fulfillers directly). While RBL has done a good job of establishing itself as the default partner for artists, more work is required to establish itself as the default destination for consumers...

RBL is a place for consumers to find original and meaningful designs on many different products. RBL's key customer desire is self-expression. The shortened supply chain means that customers can access individual, personal products at reasonable prices.

The shortened supply chain also satisfies both customers' desire to support small businesses, and the increasing sustainability agenda of customers by reducing inventory waste and the energy consumption of warehouses and distribution mileage, representing a refreshing antidote to the environmental and social externalities associated with fast fashion.

Special business characteristics – SKU convexity – enable barriers to competition. Reinvestment into greater supply has an especially outsized impact on increasing barriers to entry; new designs are multiplied by the 100+ product range to drive exponential SKU growth. Therefore, the number of unique items sold increases at a faster pace than the number of unique designs on the platform. With 60mn designs[17] and >100 products, RBL showcases *billions* of SKUs, without holding inventory. RBL can immediately enter a new product category due to the existence of millions of designs. RBL immediately becomes the largest provider on the internet with those images. Scale begets scale. And with no capital cost or inventory risk, RBL can disrupt physical retail with economics physical, or even online, retail cannot match[18].

This SKU convexity makes accelerating improvements in content discovery and customer experience possible. This is probably very hard to replicate. And it is hard to appreciate the value of nonlinear outcomes which are possible here to a an even greater degree vs. typical network businesses.

A three-sided marketplace gives rise to two potential flywheels: (1) an artist-customer flywheel: given there is no cost to artists to having their designs available on RBL's products, the number of SKUs is only likely to grow. RBL spends virtually nothing on artist acquisition. Meanwhile customer acquisition costs are suppressed by long tail search: generic search terms are more competitive, and therefore more expensive than specific, long tail, search terms. And as RBL's

[16] Solving a similar problem to Naked Wines and Next plc: allowing the vendor to focus on what they love.
[17] Much of this content is durable, perhaps evergreen.
[18] A form of counter positioning.

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range of unique items grows, so too does the probability of conversion, improving the ROI on paid search. This could be one factor supporting the sustainability of special take rates and unit economics. Customers are increasingly able to find what they are looking for as the product range increases. And (2) a customer-fulfiller flywheel: today there are 44 fulfilment partners (printers) in the US, UK, Canada, Netherlands, Germany and Australia. Distribution is decentralised[19]. That is, fulfilment centres closest to the customer are used to fulfil orders. As the size and density of the fulfilment network increases, shipping times and costs improve, increasing customer demand and pushing more volume through the fulfilment network. These economies of scale are then used to suppress shipping costs and expedite deliveries to customers. This is the essence of the customer-fulfiller flywheel. And it seems to be a flywheel only enjoyed by RBL. While Etsy sellers can connect to third-party POD fulfillers via the Etsy platform, they are striking fulfilment agreements as an individual creator, and not benefitting from the collective bargaining power of the platform. Redbubble is the largest fulfiller customer in the world[20]. With fulfilment costs representing almost half of GMV, this is an important advantage. Etsy's core customer proposition of unique and individual designs is a barrier to production scale in a way that RBL's product template standardisation is not.

This idea of collective bargaining power can be extended to RBL's ability to use its large fulfilment network to secure the best quality and prices from manufacturers of 'blanks'[21], and perhaps could be considered a third flywheel not discussed as much by management. The balance of power has shifted with RBL's increasing scale: in the early days, fulfillers had the stronger relationships with the manufacturers. This is an offline infrastructure advantage vs. online pure play businesses.

Being the largest volume POD player, RBL not only will enjoy better rates than smaller peers, but it will also be able to fill capacity more reliably at peak times. This supply chain robustness is a customer service advantage. This lends antifragility to RBL's model in times of stress. Like low-cost gyms' covenant strength and landlord relationships, Farfetch's decentralised distribution model, or Next's use of partner warehouses via Platform Plus, the value chain strengthens when under tension.

Can Etsy replicate this? While from a consumer perspective RBL and Etsy may seem similar, the business models are rather different[22]. Both RBL and Etsy offer artists global demand generation in return for a take rate. But Etsy's creators are themselves responsible for not only designing but also manufacturing and distributing the products. Likewise, Shopify may offer the online store and third-party fulfilment integration, but it is not a marketplace. There are similarities to Next

[19] Like Farfetch.
[20] Merch by Amazon is vertically integrated; AMZN owns the fulfilment capability and manufactures close to distribution. This makes sense for a player with such immense scale. For RBL owning the production assets would mean a step change in capital intensity and a brake on discretionary cash flow generation.
[21] The products onto which designs are printed.
[22] Etsy is an indirect competitor. Redbubble, Zazzle and Society6 print visual art onto standardised blanks. Etsy is not about standardised products but bespoke ones.

plc[23] and Farfetch here: business models which are marketplaces and operating systems, as such addressing the shortcomings of global leaders in both, Amazon and Shopify.

Merch by Amazon has been in existence since 2015 and does not seem to have inhibited RBL's ability to grow customers, fulfilment partners or numbers of artists and their designs. Merch by Amazon is a vertically integrated model with a narrower product set and more limited geographic reach (US mainly). There is no separate identifiable consumer proposition and so it doesn't speak so well to the artist's desire to be acknowledged, nor their ability to develop a fanbase. As to the supplier proposition, Merch by Amazon has no artist profiles/avatars, perhaps impeding consumers' ability to develop an affinity for artists and their work. RBL's decentralised production and heavily localised fulfilment network are resilient and scalable. Sometimes perceived as 'inefficiency', supply chain robustness is an underrated business quality in an uncertain world: the ability to be a reliable partner to suppliers and to delight customers in the face of supply chain disruption, trade wars and pandemics!

RBL has benefited from competitor mis-execution. Zazzle launched before RBL but has materially lagged RBL's progress in artists, designs, customers and fulfilment network. Society6 has also lagged RBL's product breadth and geographic reach. Zazzle and Society6 focused on picking and promoting the artist designs they thought would sell the most, vs. organic discovery. This upset the applecart, annoying artists and disturbing VCS. CafePress failed to scale due to a vertically integrated model of owning the printing machines.

RBL competes with unlisted operators (Threadless, Zazzle, Design by Humans), which lack access to capital markets, and companies which are smaller parts of larger groups (Merch by Amazon, Society6/Graham Holdings, CafePress/PlanetArt), which compete against other divisions for resources. Meanwhile RBL is a mission focused business solely dedicated to delighting artists and customers.

RBL's medium term revenue growth expectations are 20-30% pa. and EBITDA margin rising to 13-18% over the next three years. These growth targets are low vs. RBL's pre-pandemic five-year CAGR of 35% and Etsy's pre-pandemic five-year CAGR of 40%. RBL estimates that ecommerce spend in current product categories and geographies to be c. US$300bn, of which "35-40% of customers are seeking something unique and meaningful". RBL's GMV of c. AUD 630mn is <0.5% of this. Discretionary spending on personalised mid-tier priced products across apparel and accessories, and home décor and furnishings is clearly a huge market globally.

The potential for high incremental returns on investments are supported by RBL benefiting from the capital investments of its third-party fulfilment network, and the marketing activities of its artist community. With RBL's greater scale and SKU range, it may enjoy better ROIs on advertising spend. This is because greater brand awareness will aid conversion, and greater design and product range increases the prospects for long tail conversion. So as the company grows, it may be optimal to increase marketing spend, enjoying superior unit economics,

[23] Next also has a mission to provide suppliers the lowest cost route to market.

maximising SVA, and widening the distance between RBL and competitors. The ROI on ad spend improves as SKU variety enhances search results and puts customers in front of the entire product set, not just the products they searched for. Marketing spend should increase with greater 'surface area'.

Yet this course of action, despite being in the interests of long-term value creation, will impede the demonstration of operating leverage and higher accounting profit margins. This seems to be behind the large decline in RBL's quoted price since the start of 2021, potentially presenting a profitable time arbitrage opportunity to long duration investors.

RBL's model is scalable. Consider similar models such as Fiverr and Etsy, which also connect creative vendors and designers to consumers, but whose scalability is impeded by a one-to-one mapping of time. A spectrum of scalability exists where the more bespoke the product or service, the less scalable the model. Another example is expert networks and interviews. Bespoke one on one interviews are less scalable than user generated content platforms such as Stream and Tegus. Essentially, selling one's time has a growth and economic value ceiling. Rather than selling time, RBL's artists are selling (sometimes quite evergreen) designs, creating the possibility of very high and durable marginal gains per unit sold.

RBL has grown sales, artists, designs and customers strongly at relatively low cost; sales and marketing expenses have been c. 10% vs. peers at 11-26%. A higher-than-average take rate of c. 30%[24] also bodes well for operating leverage on SG&A[25].

Avenues to improve the monetisation of RBL's constantly growing content include improving brand awareness[26] and customer repeat rates. RBL's customers transact 1.2x pa on average. Repeat purchases are 42%[27] of marketplace revenue (MPR) and are growing 67% pa (vs. +52% for first time purchases)[28]. We might expect SKU variety improvements to enable repeat custom as consumers are more likely to find what they are looking for. Brand awareness will lower the cost of growth by increasing ROI on ad spend. Repeat rates will do the same and can be achieved by improving the first-time customer's understanding the depth and breadth of the marketplace.

Intent based search is responsible for most content discovery today; this is an impediment to both customer acquisition cost (Google in the funnel) and customer lifetime value (repeat rates) improvement. While this is an efficient process with decent conversion, it offers limited opportunity for customers to become familiar with all RBL has to offer. The challenge for RBL

[24] Etsy take rate c. 17%, AirBnB 13%, Uber 22%, Booking 14%, Zillow 14%, GrubHub 20%, eBay 8%, Next plc 39% (Tollymore holding), Farfetch 30% (Tollymore holding).
[25] Gross margin has increased from 34% to 40% FY16-21, and opex/MPR has fallen from 48% to 33% over the same period.
[26] Former Chairman Richard Cawsey: *"The opportunity is for Redbubble to become a consumer brand, rather than a place people find".*
[27] This has not declined post lockdowns, an encouraging marker of the quality of customers acquired throughout the pandemic.
[28] These repeat customer weighting and growth numbers are very similar for Etsy. However, Etsy has more customers (half of the total) who transact more than twice per year.

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will be to better present that value proposition without distracting from the transaction funnel and in the process harming conversion. Management has encouraged an experimental approach to driving repeat custom. With 10mn customers, RBL seems quite well positioned to tease out the most efficacious practices for driving repeat custom via improved understanding of what RBL is.

But there is a tension between the company achieving its target of first transaction profitability, which requires a very efficient transaction funnel, and opening the channel, which may allow for greater understanding of the proposition, but jeopardise those initial transaction economics. Management demonstrates an understanding of this tension and a long-term mindset that is willing to consider disrupting short term financial progress in the pursuit of more durable and dependable value creation:

"We're trying to move the business from single-transaction focus to much more around total customer order rate and average annual order value. We think that they are the right metrics for us to be thinking about. At the moment, there is a lot of focus around user conversion and AOV; that is right, as it's the first-time funnel. But the next evolution is to move from first-time funnel to customers' order rate, annual order value/lifetime value. That is an evolution in the business that we need to go on."

Today MPR excluding masks is c. AUD 500mn, EBITDA margin 10% and S&M 12%, implying $110mn of owner earnings, or a yield of 10%. This is not an appropriate valuation for a special business with substantial profitable growth potential[29].

Thank you for your partnership.

Mark

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[29] Note that valuation comparisons with Etsy must be adjusted for each company's different definitions of revenue . Using Etsy's definition RBL, excluding masks, generated c. AUD 190mn of revenues last year, c. 6x EV/sales, vs. Etsy at 15x. Etsy's expected revenue growth of > 30% for FY21 implies an 11x multiple. It is not appropriate to justify this difference with respect to profitability and cost structures. Using Etsy's definition of revenues, RBL's current EBITDA margin is similar to Etsy's at 32%. And management's medium-term guidance of 13-18% of MPR implies c.45% of Etsy-definition-revenues.

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