



Research Alert

VPRT

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INDUSTRY	Internet Software & Services
PRICE	\$57.07 (01/05/10)
MARKET CAP	2.46 billion
ENT. VALUE	2.30 billion
P-E RATIO	41.90
EV/REVENUE	4.20
DEBT/EBITDA	0.00
SHORT INTEREST	24.3%
DAYS TO COVER	11.7

Earnings Quality Thesis

We are initiating coverage of Vistaprint N.V. (VPRT) with a grade of F. Our initiation comes after observing a large build in accruals which may, upon reversal, pressure margins for the next several quarters. The prospect of near-term margin pressure also may be exacerbated by the recent termination of the company's margin-rich membership rewards program, rising customer-acquisition costs, and a four-quarter decline in initial profits from new customer orders. Additional concerns are raised regarding "tax arbitrage" and the sustainability of VPRT's unusually low reported effective tax rate. Finally, the low assigned grade reflects the fact that investors are paying a healthy premium for VPRT shares, while possibly underweighting risks to the sustainability of earnings.

EARNINGS QUALITY GRADE

Scale A - F

F

Buildup of accruals may signal increasing risk to sustainability of earnings and margins *pg 3*

We noted an increasing divergence between cash flows and accrual-basis earnings over the last 12 months. The result has been a sharp rise in both total and operating accruals. Total accruals represented 7.3% of average total assets in the TTM ended 09/30/09, up from just 2.3% in the same period a year ago. And though operating accruals remain negative, the increase in certain current asset accounts may pose a threat to margins in the near term.

Increases in depreciation and unwinding of prepaids could dampen margins *pg 4 and 5*

Accruals growth was primarily driven by outsized growth in CAPEX relative to depreciation and an unusual increase in prepaid expenses and other assets. Going forward, we believe that margins may face additional headwinds as depreciation expense increases with the completion of various CAPEX initiatives. Additionally, operating costs could deleverage once the increasing amounts that have been recorded to prepaid expenses and other assets begin to reverse.

Rising customer-acquisition costs and declining profits from new customers *pg 8*

Customer-acquisition costs surged 22.4% YOY during fiscal Q1. Additionally, the initial profit per new customer order plummeted by more than 70% YOY in Q1. Together, these trends may pose a threat to the sustainability of revenue growth and profit margins, particularly given the concurrent loss of margin-rich membership revenue, the expected increase in depreciation, and the unwinding of recent accruals to prepaid expenses and other assets.



01.06.10 VISTAPRINT N.V.

Research Alert

VPRT



Background and Introduction to Gradient's Thesis

COMPANY DESCRIPTION

Vistaprint N.V. (VPRT) operates as an online provider of marketing products and services to small businesses and individuals worldwide. Products offered include brochures, business cards, data sheets, desk and wall calendars, envelopes, folded cards, flyers, holiday cards, invitations and announcements, letterhead, note cards and note pads, presentation folders, and return address labels. Its nonpaper-based products include banners, car door magnets, decals, hats, key chains, lawn signs, pens, refrigerator magnets, rubber stamps, T-shirts, tote bags, and mouse pads. VPRT also provides a range of electronic and marketing services, such as caricature content, copy-writing services, e-mail marketing services, graphic design, logo design, mailing services, and Web site design and hosting services. VPRT's operations are now domiciled in the Netherlands, after a recent move from Bermuda. The firm also recently moved its corporate offices to Paris, France (Form 10Q, quarter ending 09/30/09).

REVISITING PRIOR THESIS CONCERNS GIVEN TERMINATION OF MEMBERSHIP PROGRAM OFFERINGS

Gradient previously covered VPRT from 10/19/07 to 10/29/08. Initial coverage focused on the materiality of (and risks related to) third-party referral fee revenues that had been disclosed more fully at the request of the SEC Division of Corporate Finance (see SEC letter of correspondence dated 01/10/07). During this period of coverage we also expressed concerns about VPRT's gross margin performance, increases in sales and marketing expense (relative to revenue), and higher technology and development expense (also relative to revenue). Prior coverage ended after it appeared that the relative contribution of referral fees had begun to wane, causing a decline in the company's operating margin performance.

Approximately 13 months after Gradient discontinued coverage, the company announced the termination of all membership program offerings (8K, 11/30/09). Notwithstanding the elimination of this very profitable stream of revenues, the company reaffirmed its guidance for both Q2 FY2010, ended 12/31/09, and FY2010, ending 06/30/10 (CFO Michael Giannetto, 8K, 11/30/09).

INTRODUCTION TO CURRENT INVESTMENT THESIS

VPRT shares appreciated in excess of 200% in 2009, and the stock is still trading just below its all-time closing high of \$59.02 (12/02/09). Currently the company trades at 41.9x trailing earnings and 23.1x forward earnings expectations, 7.8x book value, and 4.4x revenue. Clearly these multiples imply that the company is being priced for significant growth. Based on our review of quality of earnings and fundamental factors, however, we believe the company may have significant difficulty meeting the market's heady growth expectations.

VPRT reported a 25.5% increase in trailing 12-month (TTM) revenue to \$546.7





million. Net income also rose 46.5% YOY to \$60.4 million, driven by higher gross margins and efficiencies in scale. However, cash from operating activities (CFOA) rose just 21.1% YOY to \$123.9 million and free cash flow (FCF) remained flat at \$34.5 million over the TTM period. This implies a buildup of accruals that could provide a significant headwind as it begins to reverse in future periods.

The TTM results cited above also include revenues from referral fee arrangements, which accounted for approximately one quarter of the profits reported by VPRT over the last year.¹ This implies that the company will have to grow both the size of its customer base and the profitability of each customer order. But according to company disclosures, customer-acquisition costs spiked to the highest level in at least the last three years. Furthermore, we estimate that the initial profit per new customer order has declined for four straight quarters.

Lastly, we continue to question whether the company's effective tax rate will prove sustainable going forward. Specifically, we are concerned about recent changes in domicile and other disclosures about the firm's "tax arbitrage" (our term, defined later) strategies.

Given the premium multiple and the perceived significance of our concerns, we are initiating coverage with a grade of F.

Buildup of Accruals May Signal Increasing Risk to Sustainability of Earnings and Earnings Growth

CASH FLOWS BEGIN TO DIVERGE FROM EARNINGS

As presented in Table 1 (Page 4), net income increased 46.5% YOY during the TTM ended 09/30/09 while cash from operating activities (CFOA) increased at a relatively slower rate of 21.1% YOY. TTM free cash flow² (FCF) also remained essentially flat YOY at \$34.5 million, as a 31.2% increase in capital expenditures (CAPEX) offset the 21.1% growth in CFOA.

As a consequence of the divergence between cash flows and accrual-basis profits, Gradient's measure of total accruals³ upward to 7.3% of average total assets compared to just 2.3% a year ago. However, our measure of total accruals may be biased downward because of the unusual amount of cash provided by accrued expenses and other liabilities (and to a lesser extent, accounts payable) over the past 12 months.

On an as-presented basis, operating accruals⁴ remained negative, although increasing from negative \$30.6 million at 09/30/08 to negative \$19.4 million at 09/30/09. However, the level of accruals recorded to prepaid expenses and other assets was highly material. Additionally, the increase in CAPEX for the purchase of property, plant, and equipment and the capitalization of software and Web site development costs also contributed heavily to the rise in total accruals at the

¹ Management states that the company has not received any referral fees since 11/23/09 (8K, 11/30/09).

² FCF = CFOA – purchases of property, plant and equipment – capitalization of software and Web site development costs.

³ Accruals = net income – FCF.

⁴ Operating accruals = EBITDA – CFOA.





firm. We discuss the likely implications of these accruals in the next two sections of our *Alert*.

Table 1: Analysis of Accruals Growth
(\$ in 000s)

	12M ended:	09/30/09	06/30/09	03/31/09	12/31/08	09/30/08
Net income		\$60,389	\$55,686	\$51,318	\$48,605	\$41,225
EBITDA		\$104,449	\$96,489	\$89,128	\$82,672	\$71,740
CFOA		\$123,905	\$120,051	\$110,920	\$108,405	\$102,313
CFOA (ex. accounts payable and accrued liabilities)		\$88,404	\$92,099	\$95,785	\$91,187	\$77,750
FCF		\$34,528	\$36,597	\$30,478	\$31,989	\$34,457
FCF (ex. accounts payable and accrued liabilities)		(\$973)	\$8,645	\$15,343	\$14,771	\$9,894
Accruals		\$25,861	\$19,089	\$20,840	\$16,616	\$6,768
Accruals as % of average total assets		7.3%	5.7%	6.5%	5.3%	2.3%

Notes:

EBITDA = earnings before interest, taxes, depreciation and amortization.

CFOA = cash from operating activities.

FCF = free cash flow (defined above).

Accruals and operating accruals are defined by footnote in the above section.

Abnormal Growth in Prepaid Expenses and Other Assets

THE REVERSAL OF THESE ACCRUALS COULD PRESSURE MARGINS IN THE NEAR TERM

Over the last 12 months, the balance of prepaid expenses and other current assets surged 184.5% YOY to \$18.6 million. In fairness, the increase in accruals to these current asset accounts was partially offset by an 11.7% decline in other long-term assets. Taken together, the balance of prepaid expenses and total other assets increased 67.4% YOY to \$27.2 million in the TTM period. By either measure, however, the rate of growth in these asset accounts was well in excess of the 25.5% growth in TTM. (See Table 2, next page.)

A review of VPRT's financial disclosures did not provide any insight into what drove the increase in prepaid expenses and other assets. Regardless of the cause, we believe that the unusual increase in prepaid expenses and other assets could pressure margins going forward as the underlying accruals reverse into expense accounts over the next 12 months.

Had the relative level of prepaid expenses and other current assets (prepaid and total other assets) remained constant at the level seen in the TTM ended 09/30/08 (or 1.5% and 3.7% of revenues, respectively), the company would have recognized \$10.4 million (\$6.8 million) in additional operating expenses over the last 12 months. For context, this is equivalent to 15.7% (10.3%) of reported operating income for the TTM period.





Table 2: Analysis of Outsized Growth of Other Assets
(\$ in 000s)

	Period ended:					
	09/30/09	06/30/09	03/31/09	12/31/08	09/30/08	
12M revenue	\$546,686	\$515,827	\$491,066	\$469,322	\$435,436	
% change YOY	25.5%	28.7%	35.4%	43.8%	52.6%	
Prepaid expenses and other current assets	\$18,618	\$12,819	\$5,683	\$7,202	\$6,545	
% change YOY	184.5%	125.8%	-24.7%	0.9%	20.1%	
Other assets (long-term)	\$8,549	\$5,275	\$9,979	\$9,655	\$9,679	
% change YOY	-11.7%	-41.5%	29.3%	37.6%	93.0%	
Total other assets	\$27,167	\$18,094	\$15,662	\$16,857	\$16,224	
% change YOY	67.4%	23.1%	2.6%	19.1%	55.1%	
Prepaid expenses and other current assets/TTM revenue	3.4%	2.5%	1.2%	1.5%	1.5%	
% change YOY	126.6%	75.4%	-44.3%	-29.8%	-21.3%	
Total other assets/TTM revenue	5.0%	3.5%	3.2%	3.6%	3.7%	
% change YOY	33.4%	-4.4%	-24.2%	-17.2%	1.6%	

Increase in Depreciation Expense May Also Pressure Margins

JUMP IN CIP SIGNALS INCREASED DEPRECIATION EXPENSE AHEAD

VPRT has reported a steady rise in depreciation and amortization relative to sales since Q2 FY2007 (ended 09/30/06), in which depreciation and amortization as a percentage of revenue stood at 5.0%. As shown in Table 3 (Page 7), depreciation and amortization as a percentage of revenue rose 48 basis points (bps) YOY to 6.9% during the TTM ended 09/30/09. And in the most recent quarter, depreciation and amortization represented 7.1% of revenue. We believe this trend may continue for the foreseeable future, posing an additional source of risk to VPRT's margins.

VPRT reported a 31.7% YOY increase in CAPEX to \$89.4 million in the latest TTM period.⁵ While depreciation and amortization expense did grow ahead of CAPEX, the CAPEX-to-depreciation ratio remains elevated (above 2.0, see Table 3) as result of a buildup of construction in progress (CIP), which is not depreciated. At the end of Q4 FY2009, CIP had increased 103.8% YOY to \$27.7 million (or 7.5% of total assets). This represents both the highest absolute and relative (to total assets) level of CIP since the company went public. According to the latest 10K filing, CIP consisted of expansion of the company's Canadian and Dutch and other facilities and the purchase of information technology-related assets.

Based on the level of depreciation expense relative to average depreciable property, plant, and equipment (PP&E) at 09/30/09, it appears that assets are being depreciated over an average useful life of approximately 6.65 years.⁶ Assuming that all CIP on the books at 06/30/09 will (1) transfer into depreciable PP&E ratably during FY2010 and (2) depreciate over a weighted-average useful life of 6.65 years, the incremental depreciation expense recorded in FY2010 will be approximately \$2.1 million (or half of the annual run rate of \$4.2 million).

⁵CAPEX includes purchases of property, plant, and equipment plus the capitalization of software and Web site development costs.

⁶Our computation is average depreciable assets, or (beginning balance + ending balance)/2, divided by TTM depreciation expense.





EVALUATING THE POTENTIAL IMPACT OF FORECASTED FY2010 CAPEX

During the latest earnings announcement (10/29/09), management indicated that CAPEX would total between \$80 million and \$95 million during FY2010. The company further indicated that two largest contributors to forecasted FY2010 CAPEX were the build-out of an Australian manufacturing facility (expected to be online in Q1 FY2011) and the expansion of the company's Canadian manufacturing facility (expected to be completed by the end of FY2010).

In order to assess the near-term impact of forecasted FY2010 CAPEX, we assume that the \$22.0 million associated with the build-out of the company's Australian production facility will be held in CIP until FY2011. Therefore it should have no effect on depreciation for FY2010. Furthermore, we assume that the \$65.5 million balance of forecasted FY2010 CAPEX (computed as the midpoint of guidance, or \$85.5 million, less \$22.0 million) will be associated with the company's expansion of current facilities and for the purchase of additional information technology assets. Assuming further that the \$65.5 million increase in capital assets will be depreciated over 6.65 years, we estimate that increase in annual depreciation will total \$9.8 million. Finally, if these assets are placed in service ratably during the year, it will result in an additional \$4.9 million in depreciation during FY2010.

To illustrate the potential near-term margin impact of incremental depreciation from current CIP and planned CAPEX, we assume that the depreciation and amortization expense recognized in FY2009 (\$35.7 million) will carry forward into FY2010. Then, by adding the estimated incremental depreciation expense associated with CIP (\$2.1 million) and planned FY2010 CAPEX (\$4.9 million), we estimate that depreciation expense will increase by approximately \$7.0 million over the next 12 months. This would result in an estimated recognition of \$42.7 million of depreciation and amortization during FY2010.

If depreciation expense were to increase by our projected value of \$7.0 million, VPRT would need to grow sales by \$98.7 million (19.1%) in order to contain depreciation and amortization to just 6.9% of revenue. Given the current trajectory of revenue growth, a 19.1% increase would appear to be reasonably attainable. However, this goal may be more difficult to attain given loss of membership program revenues, the rising cost of customer acquisition, and relatively lower revenues per new customer order. Moreover, even if the company were able to maintain depreciation at 6.9% of revenues, pretax margins are still likely to be at risk because of the anticipated reversal of recent accruals and the loss of high-margin membership program revenues. We discuss the latter issue next.





Table 3: Analysis of CAPEX, Depreciation and Amortization Growth (\$ in 000s)

	12M ended:	09/30/09	06/30/09	03/31/09	12/31/08	09/30/08
CAPEX		\$89,377	\$83,454	\$80,442	\$76,416	\$67,856
Percent change YOY		31.7%	19.8%	9.9%	4.9%	-2.9%
Depreciation and amortization (D&A)		\$37,969	\$35,713	\$33,415	\$30,771	\$28,168
Percent change YOY		34.8%	41.8%	49.6%	56.4%	62.8%
CAPEX to D&A		2.35	2.34	2.41	2.48	2.41
Percent change YOY		-2.3%	-15.5%	-26.5%	-32.9%	-40.3%
Depreciation and amortization as a percent of 12 month revenue		6.9%	6.9%	6.8%	6.6%	6.5%
Basis point change YOY		48	64	65	53	41

Margins Also May Face Pressure from Several Key Fundamental Changes

CAN VPRT OFFSET THE LOSS OF MEMBERSHIP PROGRAM REFERRAL REVENUES?

Consistent with Gradient's previously expressed concerns, it is now clear that the majority of referral fee revenue has historically been associated with high-margin membership reward programs. For example, during FY2009 (FY2008), 78.0% (89.9%) of referral fee revenue was associated with membership rewards programs. However, during Q1 FY2010, membership reward programs declined to 65.4% of referral fee revenue.⁷

Going forward, we expect that VPRT may continue to generate a residual level of referral fee revenue for services that the company views as complimentary to its product offering. Based on the breakdown of membership program revenue and total referral fee revenue as a percentage of total revenue, it appears that 1.2% of revenue during Q1 FY2010 was associated with referral fees other than membership programs, up from 1.1% in FY2009 and 0.7% in FY2008. While we continue to view the residual referral fee revenue (i.e., that which is not associated with membership programs) as being non-core in nature, we believe it will likely prove sustainable going forward.

As shown in Table 4 (next page), the profits attributable to membership program revenue represented approximately 23.2% of operating income in Q1 FY2010. Though the contribution of profits from membership revenues is down substantially from 60.4% of operating income in FY2008, the amount of related profits remains highly material to earnings. In this context, the elimination of nearly a quarter of the company's Q1 earnings power will create a significant gap for management to fill (via core operating activities) in future periods.

As demonstrated in Table 5 (next page), it appears that adjusted (i.e., "core") gross margins have been increasing, improving to 62.7% of revenue in Q1 FY2010 from 61.3% of revenue in FY2009 and 59.0% of revenue in FY2008. On the other

⁷ It should be noted that VPRT enhanced its disclosure quality since we terminated active coverage of the company by breaking down the percentage of referral fee revenue associated with membership programs. In contrast to when we initially began covering the company, VPRT now discloses that there is little direct cost associated with referral fee revenue.





hand, Q1 FY2010 adjusted operating margin (7.8%) is below full-year FY2009's adjusted operating margin (8.4%). While Q2 tends to be the company's most margin-rich quarter, it remains to be seen whether the seasonally rich nature of Q2 can fully offset the effect of eliminating most of the firm's profits from membership programs. As we discuss in the next section, the company also may be facing additional margin headwinds due to rising customer-acquisition costs and lower initial profits from new customer orders.

Table 4: Analysis of Membership Program Revenue
(\$ in 000s)

	Q1 FY2010	FY2009	FY2008
Membership program revenue as a % of revenue	2.3%	3.9%	6.2%
Membership program revenue as a % of gross profit	3.6%	6.2%	10.1%
Membership program revenue as a % of operating income	23.2%	32.7%	60.4%

Table 5: Fundamental Performance Excluding Membership Reward Revenue
(\$ in 000s)

	Q1 FY2010	FY2009	FY2008
Total revenue	\$145,091	\$515,827	\$400,657
Membership fee revenue	\$3,337	\$20,117	\$24,841
Other referral fee revenue	\$1,763	\$5,674	\$2,805
Referral fee revenue	\$5,100	\$25,791	\$27,645
Gross profit	\$92,226	\$323,882	\$246,535
Adjusted gross profit	\$88,889	\$303,765	\$221,694
Gross margin	63.6%	62.8%	61.5%
Adjusted gross margin	62.7%	61.3%	59.0%
Operating profit	\$14,406	\$61,580	\$41,159
Adjusted operating profit	\$11,069	\$41,463	\$16,318
Operating margin	9.9%	11.9%	10.3%
Adjusted operating margin	7.8%	8.4%	4.3%
Net income	\$12,976	\$55,684	\$39,830
Adjusted net income	\$9,957	\$37,350	\$17,390
Net margin	8.9%	10.8%	9.9%
Adjusted net margin	7.0%	7.5%	4.6%

Rising Customer-Acquisition Costs and Declining Profits from New Customers

SURGE IN CUSTOMER-ACQUISITION COSTS COULD PRESSURE MARGINS FURTHER

Advertising expense surged 43.3% YOY to \$29.1 million in the latest TTM period versus a comparatively slower 25.5% growth in sales. As a consequence, advertising expense was equal to 20.1% of revenue, up 229 basis points YOY and representing the highest level of advertising expense relative to revenue since Q4 FY2007 (ended 06/30/07). In general, rising levels of advertising expenses relative to revenue suggests that revenue growth is becoming more expensive, indicating that the firm must either scale back on its revenue growth plans or accept lower contribution margins.





During the most recent quarter, VPRT added 1.4 million new customers, representing a 16.7% increase YOY (Q1 FY2010 earnings release). Dividing advertising expense by the number of new customers added during a quarter, we compute that the cost of customer acquisition (COCA) rose 22.9% YOY to \$20.79—which is the highest cost per new customer addition in at least the last three years.⁸

During the question and answer segment of the company's Q1 FY2010 earnings call (10/29/09), management indicated that the increase in advertising was due to new brand broadcasting tests and additional offline marketing tests. Nevertheless, it appears that the initial profit on new customer orders has been trending down for four straight quarters.

REVENUE AND PROFIT PER NEW CUSTOMER DECLINES DRAMATICALLY

Despite the rise in COCA, revenue derived per initial customer order appears to be flattening. Each quarter, VPRT discloses the level of bookings generated by repeat customers. For our purposes, we assume that “bookings” is equivalent to recognized revenue during the quarter. Working backward, this allows us to utilize the percentage of bookings not derived from repeat customers as a proxy for revenue generated per new customer. Under this assumption we find that during the most recent quarter, new customer initial order value increased 5.7% YOY to \$34.20, which is in line with the average order value for all orders (\$34.23, per management).

Our concern relates to the decline in initial profit per new customer. We have estimated the initial profit per new customer as the estimated revenue per new customer order multiplied by two alternative gross-profit metrics (as reported gross margin and adjusted gross margin, to remove high-margin referral fees) minus COCA. Based on this methodology, our estimated initial profit per new customer declined by approximately 65.3% (73.9%) YOY to just \$0.95 (\$0.50) when utilizing the company's as-presented (adjusted) gross margin.

During the Q1 FY2009 earnings call, management indicated that the average customer generated \$63.00 in revenue during FY2009, and as such, the company was still earning a profit on each new customer acquired. Regardless, we believe that the sharp and persistent decline in estimated initial profit per new customer order may be indicative of an unavoidable decline in economies of scale. If so, management may need to rethink its revenue growth plans or revise its profit-margin expectations. And either of these two outcomes, if realized, could have important valuation implications for the firm.

⁸ While some portion of advertising expense may be attributable to an increase in orders from return customers, there is no way for an outsider to quantify this effect. Therefore we prefer to attribute all advertising costs to the base of new customers acquired in the period. Though this measure is arguably biased upward, as long as it is computed consistently we believe that it reveals important information about the trend in customer-acquisition costs.





Table 6: Analysis of Customer Acquisition Costs and Initial Return Per New Customer (\$ in 000s)

	3M ended:	09/30/09	06/30/09	03/31/09	12/31/08	09/30/08
Revenue		\$145,091	\$135,169	\$127,523	\$138,903	\$114,232
% change YOY		27.0%	22.4%	20.6%	32.3%	43.8%
Revenue from new customers		\$47,880	\$44,606	\$43,358	\$48,616	\$38,839
% change YOY		23.3%	15.4%	13.9%	25.1%	35.8%
Advertising expense		\$29,100	\$24,700	\$24,400	\$27,800	\$20,300
% change YOY		43.3%	26.0%	22.6%	33.0%	32.7%
Advertising expense as a % of revenue		20.1%	18.3%	19.1%	20.0%	17.8%
Basis point change YOY		229	52	32	11	(149)
New customers		1,400	1,400	1,500	1,500	1,200
% change YOY		16.7%	16.7%	25.0%	36.4%	23.1%
Cost of customer acquisition (COCA)		\$20.79	\$17.64	\$16.27	\$18.53	\$16.92
% change YOY		22.9%	8.0%	-1.9%	-2.5%	7.8%
Initial new customer order value		\$34.20	\$31.86	\$28.91	\$32.41	\$32.37
% change YOY		5.7%	-1.1%	-8.9%	-8.2%	10.3%
Initial return per new customer (as presented gross margin)		\$0.95	\$2.47	\$2.08	\$2.05	\$2.74
% change YOY		-65.3%	-22.1%	-27.3%	-29.4%	3.2%
Initial return per new customer (adjusted gross margin)		\$0.50	\$1.96	\$1.49	\$1.48	\$1.91
% change YOY		-73.9%	-14.9%	-24.5%	-26.3%	17.4%

Note: Cost of customer acquisition, Initial new customer order value, and Initial return per new customer is presented in absolute dollars.

Will VPRT's Effective Tax Rate Prove Sustainable?

What explains the recent move to the Netherlands?

A recent G20 nations crackdown on certain countries thought to have accommodated tax evasion has led to a shuffling of corporate domiciles by firms in the insurance and other financial services industries. A handful of industrial and consumer-oriented firms, including VPRT, also relocated their corporate domiciles during this period.

According to VPRT management (press release dated 04/30/09), the decision to move its operations and corporate headquarters from Bermuda was a result of "careful consideration [by] our Board of Directors [which] concluded that it is in the best interests of VistaPrint and our shareholders to move our corporate domicile to the Netherlands and to re-establish an office in France that operates under the French headquarters tax legislation." The company went on to state that "The Netherlands and France have highly stable economic, political and regulatory environments, as well as long-established commercial relationships and tax treaties with countries around the world" and that, with these relocations, "VistaPrint does not expect any material change in its financial results or its effective consolidated tax rate..."

While Gradient does not express an opinion on the change in VPRT's corporate domicile, we believe that "tax arbitrage" strategies⁹, such as those employed by VPRT, should be carefully weighed in any investment decision. It is our opinion

⁹ We define "tax arbitrage" as any strategy designed to reduce a firm's effective tax rate to a level that is significantly below the median tax rate in developed nations. These are, in essence, the same strategies that the tax accounting profession refers to as "tax planning."





that tax arbitrage often signals that (1) a firm's net profit margins computed consistent with the tax regime of most developed nations would be unattractive to investors and/or (2) that the ability to increase margins by improvements in core operations is relatively limited.

IS VPRT'S EFFECTIVE TAX RATE SUSTAINABLE?

Another potential consequence of "tax arbitrage" is the possibility that related tax savings may prove unsustainable if scrutinized carefully by tax authorities. As we discuss below, certain publicly available disclosures made by VPRT suggest that the firm's effective tax rate may not be sustainable, at least not with respect to profits reported to tax authorities in the U.S.

During Q1 FY2010, VPRT's effective tax rate declined 93 bps YOY to just 9.5% of earnings before tax. On a trailing 12-month basis, the company's effective tax rate also declined 98 bps to 8.8% of earnings before taxes. According to company management, the decline in the company's tax rate was a result of a shift in geographical mix of the company's earnings.

VPRT has been able to maintain a significantly low tax rate as a result of the company's complex business structure. Specifically, the company utilizes intercompany arrangements, including transfer pricing agreements, in order to source a portion of its profits in lower tax jurisdictions.¹⁰ While VPRT asserts that it has made arrangements with Dutch and French tax authorities, according to the company's most FY2009 10K, its other "transfer pricing arrangements are not binding on applicable tax authorities and no official authority in any other country has made a determination as to whether or not we are operating in compliance with its transfer pricing laws."

With only publicly available disclosures to work with, our ability to make inferences about the risk of an increase in the firm's effective tax rate is somewhat limited. Nevertheless, certain disclosures contained in the firm's FY2009 10K point to an apparent disconnection between economic reality and the attribution of firm profits to tax jurisdictions. As illustrated in Table 7 (next page), management states that 60.8% of FY2010 revenues come from its U.S.-based Web site(s). Yet tax-related footnotes provided in the same 10K state that just 15.4% of earnings before taxes were sourced in the U.S. Taking these two figures at face value leads one to conclude that pretax margins on U.S. sales are just 3.0% versus the 11.8% pretax margin realized worldwide. Furthermore, by extension, the company reports that 39.2% of revenues were attributable to sales made on non-U.S. Web sites, but 84.6% of pretax profits are attributable to non-U.S. jurisdictions. This works out to a 25.6% pretax margin for non-U.S. operations. The immense gap in profits attributable to U.S. and non-U.S. operations is

¹⁰ The company utilizes intercompany arrangements, including transfer pricing agreements, in order to establish the prices that one portion of the company in the group charges to others in the group for goods, services or the use of property. In theory, and by law (in the U.S.), the prices charged between different companies within a group should be substantially similar to those charged between unrelated companies dealing at arm's length. However, this is a subjective matter that can lead to a fair amount of divergence of opinion.



difficult to fathom, unless it is due in part to tax arbitrage.

On the other hand, we readily admit that the motives of tax authorities are a “mystery wrapped in an enigma.” Thus, we are unable to opine on whether the apparent discrepancy between economic reality and the attribution of corporate profits at VPRT rises to a level that would warrant additional regulator scrutiny. We do, however, believe that the firm’s tax strategy may be reflective of an expectation that margins are likely to remain relatively thin, even as the firm grows in scale. As such, this view is consistent with our thesis that investors may be overly optimistic in assessing VPRT’s future profit potential.

Table 7: Geographical Analysis of Revenue and Earnings Before Taxes (\$ in 000s)

	FY ended:	06/30/09	06/30/08	06/30/07	06/30/06
<u>Income before tax by geographic region</u>					
U.S.		\$9,402	\$8,068	\$4,107	\$2,249
Non-U.S.		\$51,701	\$36,024	\$25,916	\$17,769
Total		\$61,103	\$44,092	\$30,023	\$20,018
<u>Revenue by geographic region</u>					
US		\$313,621	\$249,017	\$173,414	\$108,524
Non-US		\$202,205	\$151,640	\$82,519	\$43,625
Total revenue		\$515,826	\$400,657	\$255,933	\$152,149
<u>EBT margin by geographic region</u>					
U.S. Margin		3.0%	3.2%	2.4%	2.1%
Non-U.S. Margin		25.6%	23.8%	31.4%	40.7%
Combined margin		11.8%	11.0%	11.7%	13.2%

Evaluating the Current Share Price in Light of Gradient’s Estimate of Sustainable Earnings

IS THE SHARE PRICE JUSTIFIED BY THE EARNINGS POWER DEMONSTRATED TO DATE?

As discussed earlier, it appears that VPRT is priced for significant growth, with the company trading at 41.9x trailing 12-month earnings. However, that multiple may be much higher if the firm’s sustainable earnings are lower than as-presented earnings.

In order to estimate VPRT’s sustainable earnings reported for the last TTM period, we make two initial adjustments to reported earnings before taxes. We first start with the removal of membership rewards program referral fee revenue. Based on the assumption that membership program fee revenue as a percentage of revenue was level throughout FY2009 (at 3.9% of revenue) and incorporating the 2.3% of revenue figure reported for Q1 FY2010, we estimate that \$19.0 million of reported earnings before taxes was attributable to these fees.

Next, we adjusted for the unusual buildup in prepaid expenses and other assets. We deducted the lower of our two estimates, or \$6.8 million, which is based on the growth in prepaid expenses and total other assets.





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Combined, these two adjustments reduced TTM pretax income by \$25.8 million, or 39%. Then, applying the as presented effective tax rate for the TTM period (8.8%), we estimate sustainable earnings (EPS) of \$36.9 million (\$0.83), yielding a price-to-sustainable EPS multiple of 68.7x.

Finally, we note that the multiple is even higher if we assume that the firm's sustainable tax rate should reflect a higher proportion of earnings taxable in the U.S. In this context, if we assume that taxable income were attributed to jurisdictions in proportion to sales generated within each country, then approximately 60% of VPRT's sustainable earnings would be taxable in the U.S. If those earnings were taxed at 35%, sustainable net income falls further to \$31.9 million or \$0.72 per share. This would imply that a current multiple of 79.4x TTM sustainable earnings.

Finally, even if one disagrees with the adjustments made in estimating sustainable earnings, we believe these observations are still very important in assessing the likelihood that the company can meet its growth targets. In this regard, we believe the firm still trades at an unsustainable multiple even on the basis of as-presented EPS.

Conclusion and Risks to Thesis

CONCLUSION

Based on our analysis, it appears that investors are paying a substantial premium for VPRT shares. The size of that premium (or at least the risk associated with overpaying for VPRT shares) appears even greater when we consider that the large build in accruals over the last 12 months may pressure margins in the near term. Compounding this problem we believe that margins will be adversely affected by the elimination of the firm's membership programs and the increasing cost of customer acquisitions. Reflective of the severity of our concerns, we are initiating coverage with a grade of F.

RISKS TO THESIS

If VPRT is able to accelerate revenue growth, it may be able to avoid the potential margin compression discussed herein. Additionally, depending on the prevailing winds of tax regulatory regimes, the firm may be able to maintain the relatively low effective tax rate reported to date.





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