

BBY Company Research		8 December 2014			
<h1>Digital CC Limited</h1>					
DCC	A\$0.15	TARGET PRICE	A\$0.54	BUY	0.0X
digitalBTC is an innovative digital payments company providing investors exposure to multiple facets of the Bitcoin industry and the digital payments sector, including bitcoin mining, trading and consumer wallet applications.				Marc Kennis 02 9226 0167 mak@bby.com.au	

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A pure, but diversified, Bitcoin play

- ◆ Bitcoin is a peer-to-peer digital currency network that facilitates instant and secure transfer of bitcoins (BTC) between any two people in the world that have a digital bitcoin wallet. BTC is a form of electronic cash that can be used for payments and money transfers similar to fiat currency, without the need for intermediaries like banks.
- ◆ digitalBTC (DCC) is active in this rapidly developing, digital industry through mining (verification) of BTC, leasing mining (verification) equipment to third parties, providing liquidity of BTC to the market and developing consumer products, such as digital wallets.
- ◆ BTC *mining* is the process of verifying transactions in this digital currency system, in which records of current BTC transactions are added to the existing ledger. For each block of transactions they verify, BTC miners, such as DCC, receive a reward in the form of BTC that they can sell on the open market.
- ◆ Even though revenues from BTC mining will be dominant in the next few years, we expect DCC to ramp up recently developed mining lease and payment applications, which should substantially drive non-mining revenues. In addition, new applications aimed at improving ease-of-use of BTC for consumers and at leveraging the Bitcoin protocol in areas other than BTC mining should drive revenue differentiation at DCC going forward.
- ◆ Such areas, i.e. where knowledge and expertise of the Bitcoin protocol can be applied, include insurance policies, trading of financial instruments such as stocks, digital media titles, crowd funding, shared ownership of physical assets etc. As these areas are in very early stages of development, we have not included these ventures into our model.
- ◆ In our view, DCC provides an excellent opportunity for investors to gain exposure to the fast growing Bitcoin industry, both BTC mining and diversified BTC services.

Valuation

- ◆ Valuing DCC on a multiples basis is complicated due to lack of truly comparable peers. Therefore, DCF is our preferred method for DCC. In a blue skies scenario DCC can be valued at approximately A\$1.00 per share. However, due to substantial uncertainties in this newly emerging industry and execution risks with respect to roll out of non-mining applications over the next few years, we initiate our coverage of DCC with a BUY recommendation and a price target of A\$0.54.

Company Data

Number of shares	168.8M
Market capitalisation	A\$ 25M
Free Float (%)	
12 month high/low	A\$0.63/A\$0.10
Average monthly turnover	A\$2 M
% S&P/ASX 200	n/a
% All Ordinaries	n/a
DDM Ranking	
ESG Score (Ranking)	n/a
GICS Industry Group	Diversified Financials

BBY vs Consensus

	BBY FY1	Consensus FY1	% Difference
EBITDA (\$m)	11.1		
NPAT (\$m)	2.8		
EPS (c/sh)	1.7		

BBY Technical View – as at 5/12/2014

Short Term	Downtrend Resistance	\$0.267
Long Term	Downtrend Support	\$0.083

Earnings Summary (USD)

Year end June	2014F	2015F	2016F	2017F
Revenue (\$M)	4.4	17.6	22.7	18.6
EBITDA (\$M)	2.0	11.1	16.5	11.9
Reported NPAT (\$M)	-11.2	2.8	5.4	4.4
Reported EPS (¢)	-11.7	1.7	3.1	2.4
EPS growth		n.m.	84%	-22%
Adjusted P/E (x)		9.2	4.8	5.9
Dividend (¢/sh)	0%	0%	0%	0%
Gross yield (%)	0.0	0.0	0.0	0.0
EV/EBITDA (x)		1.09	0.46	0.25
Free cash flow yield	n.m.	1.4%	16.4%	27.8%

DCC Share Price Performance



Financial Summary

Digital CC Limited

 Share Price (A\$) **\$0.15**

Mkt Cap (A\$M)

25

Year ending June 30

Profit & Loss (US\$M)	2014A	2015F	2016F	2017F
Total Revenue	4.4	17.6	22.7	18.6
Growth (%)		298.9	29.0	(18.0)
EBITDA	1.7	11.1	16.5	11.9
Growth (%)		nm	49.1	(27.8)
Dep'n and amort'n	(1.8)	(7.2)	(9.0)	(6.0)
EBIT	(0.2)	3.9	7.5	5.9
Net interest expense	(0.1)	0.1	0.2	0.4
PBT	(11.2)	4.0	7.8	6.3
Growth (%)		136.0	92.9	(18.4)
Tax	0.0	(1.2)	(2.3)	(1.9)
NPAT Underlying attrib.	(11.2)	2.8	5.4	4.4
Growth (%)		125.1	92.9	(18.4)
NPAT Reported	(11.2)	2.8	5.4	4.4
Normalised NPAT	(11.2)	2.8	5.4	4.4
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Ord Shares	9	168.8	185.4	185.4
Options	35.8	35.8	35.8	35.8
Fully Diluted	205.9	205.9	205.9	205.9
FD Wgtd Av Shares	205.9	205.9	205.9	205.9

Cashflow (US\$M)	2014A	2015F	2016F	2017F
Customer receipts	2.1	17.6	22.7	18.6
Supplier Payments	(2.4)	(6.5)	(6.2)	(6.7)
Net interest paid	(0.1)	0.1	0.2	0.4
Taxes Paid	0.0	(1.2)	(2.3)	(1.9)
Net operating cash flow	(1.5)	10.0	14.4	10.4
Capex	(4.1)	(7.9)	(7.5)	(6.0)
Net investing cash flow	(4.0)	(7.9)	(7.5)	(6.0)
Dividends paid	0.0	0.0	0.0	0.0
Net financing cash flow	10.1	0.0	0.0	0.0
Net Change in cash	4.6	2.1	6.9	4.4
Net cash at end of period	4.6	6.7	13.6	18.0
Change in working capital	(8.4)	(2.1)	(6.9)	(4.4)

Balance sheet (US\$M)	2014A	2015F	2016F	2017F
Cash	4.6	9.2	15.7	20.4
Receivables	2.2	0.5	0.6	0.5
Inventories	2.3	1.8	2.3	1.9
Current assets	9.3	12.3	19.7	23.7
Tangible Assets	2.3	3.0	1.5	1.5
Investments	0.0	0.0	0.0	0.0
Goodwill	0.0	0.0	0.0	0.0
Total assets	11.6	15.4	21.3	25.3
Payables	0.4	1.0	1.2	1.0
Current Term debt	0.0	0.0	0.0	0.0
Long term debt	0.0	0.0	0.0	0.0
Total liabilities	0.9	1.9	2.4	2.0
Total Shareholder Equity	10.7	13.5	18.9	23.3

Investment summary	2014A	2015F	2016F	2017F
NPAT reported	(11.2)	2.8	5.4	4.4
NPAT Underlying	(11.2)	2.8	5.4	4.4
EPS Reported	(5.4)	1.4	2.6	2.2
EPS Underlying	(5.4)	1.4	2.6	2.2
EPS Growth (%)		125.1	92.9	(18.4)
Dividend (¢/sh)	0.0	0.0	0.0	0.0
Payout Ratio (%)	0.0	0.0	0.0	0.0
Gross Yield (%)				
Net Yield (%)				
Franking (%)	0.0	0.0	0.0	0.0

Key Ratios	2014A	2015F	2016F	2017F
Profitability (%)				
EBITDA	1.7	11.1	16.5	11.9
EBITDA/Rev (%)	38.0	62.9	72.7	64.0
EBIT	(0.2)	3.9	7.5	5.9
EBIT/Rev (%)	(3.5)	22.2	33.2	31.9
NPAT	(11.2)	2.8	5.4	4.4
NPAT/Rev (%)	(254.1)	16.0	23.9	23.8
ROE (%)	(210.1)	23.3	33.5	20.9
ROA (%)	(2.7)	29.0	41.0	25.5
ROIC (%)		25.6	40.1	28.5
Financial Strength				
Debt to equity (%)	0.3	0.2	0.0	0.0
Net debt (\$M)	(4.5)	(9.2)	(15.7)	(20.4)
Net debt to equity (%)	(42.6)	(67.9)	(83.1)	(87.5)
Net Debt to EBITDA (%)	(2.7)	(0.8)	(1.0)	(1.7)
Interest Cover EBIT (x)	(1.3)	2,056.0	3,960.1	na
Current Ratio (x)	10.1	6.7	8.3	12.2
Quick Ratio (x)	7.5	5.7	7.3	11.2
Valuation				
Operating cash flow	(1.5)	10.0	14.4	10.4
CFPS (¢ - FD)	(0.7)	4.8	7.0	5.1
Price/CF	(46.7)	2.6	1.8	2.5
BV per share (\$)	0.1	0.1	0.1	0.1
Price/Book Value (x)	5.5	1.6	1.2	1.0
NTA (\$)	10.6	13.5	18.9	23.3
NTA per share (\$)	0.1	0.1	0.1	0.1
Price/NTA (x)	5.5	1.6	1.2	1.0
EV/Sales (x)	6.6	0.1	(0.2)	(0.5)
EV/EBITDA (x)		1.1	0.5	0.3
EV/EBIT (x)	(187.3)	0.4	(0.7)	(1.7)

Source: BBY, Company Reports. BBY contributes all company estimates to Bloomberg, Thomson Reuters, FactSet and Capital IQ.

Note: Numbers displayed are a sub-set

The ESG (Environmental, Social, Governance) score is a measure of the sustainability and ethical impact of an investment in this company or product. ESG scores range from 0.1 (min) to 100 (max). ESG scores are provided to BBY by Bloomberg and are only available for those companies that disclose ESG data to Bloomberg.

Company profile: a pure Bitcoin play

DCC is active in the rapidly developing digital payments/currencies industry through mining of bitcoins (BTC), providing liquidity of BTC to the market and development of retail consumer products, such as digital wallets.

Currently, the company's main source of revenues is BTC mining (90% of revenues in FY14). Due to the specific nature of BTC mining and the structure of the industry, which we will elaborate on below, mining revenues will likely decline over time. Therefore, DCC is developing other sources of income related to the bitcoin industry. One such source of income is BTC trading facilitation for companies such as ATM providers and hedge funds, similar to a foreign exchange desk at a bank or broker. Additionally, DCC provides liquidity to the market by leveraging its own inventory of mined BTC. Other future sources of revenue will be specific apps focussed on enabling consumers to take full advantage of the benefits of bitcoin. These apps are currently being developed and include products such as digital wallets on mobile phones, tablets or PC's that allow consumers to buy goods and service online as well as offline, i.e. in brick and mortar stores, using BTC.

Given the complexity of BTC mining and our expectation that it will remain DCC's dominant source of revenues for the foreseeable future, we will start off by explaining the basics of BTC mining.

Bitcoin mining 101

The principle of bitcoin¹

Bitcoin is a peer-to-peer digital currency network that facilitates instant and secure transfer of bitcoins (BTC) between any two people in the world that have a digital bitcoin wallet. BTC is a form of electronic cash that can be used for payments, money transfers etc. similar to fiat currency. One of the key elements of bitcoin is that it is a peer-to-peer network and does not require an intermediary such as a bank to verify transactions. Instead, the Bitcoin network verifies each block of transactions itself through cryptography and computer processing power and adds it to a public ledger, called the block chain. This is done by the members of the network, consisting of many individuals and professional entities worldwide, known as bitcoin *miners*, each contributing their own computer processing power to the network. Bitcoins are created as a reward for this processing and verification work.

In other words, Bitcoin *mining* is the process of verifying transactions in the digital currency system, in which the records of current BTC transactions, known as a blocks, are added to the record of past transactions, the public ledger or block chain. After each addition of a new block, the new block chain information is distributed to all miners in the network so independent verification of BTC ownership can take place.

As a consequence, it is visible to the entire network when a particular Bitcoin has been spent and who the recipient was. This is necessary to prevent double-spending in the absence of a central authority or clearing house. A new verified block of transactions is added to the block chain approximately every 10 minutes. The Bitcoin network is open to anyone with a computer wishing to join.

The mining reward

The first miner that successfully verifies and adds a new block of BTC transactions to the block chain will receive a reward of 25 BTC. At today's BTC market price of around USD 400, this translates into a reward of USD 10,000 per block, or USD 60,000 every hour, or USD 1.44 million every 24 hours. Given this monetary attractiveness, an arms race has developed among miners in which the miners with the most powerful computers will reap most of the mining rewards.

The hard part: Verifying transactions

However, to understand why miners need very fast, state-of-the-art computers, we need to have a closer look at the mining, or the transactions verification, process².

As discussed, mining is essentially a record-keeping service to keep the block chain accurate and secure. In order to maintain the integrity of the block chain, i.e. making sure the same BTC isn't spent twice by the same person and keeping track of who owns which BTC's, the Bitcoin protocol uses advanced cryptography.

¹ The creation of the bitcoin protocol and reference software is widely attributed to Satoshi Nakamoto, believed to be a pseudonym for a person or a group of people. A white paper published in 2008 ("Bitcoin: A Peer-to-Peer Electronic Cash System") is considered to be the starting point for Bitcoin.

² The actual Bitcoin protocol is mathematical in nature and uses advanced cryptography. The inner working of the protocol is highly complex and for purposes of this report we will provide a simplified explanation to help understand the basics of Bitcoin mining.

The actual mining, or transaction verification, is in fact the calculation of a *hash*, which is created by a *hash function*. A hash function can be used to convert digital data of arbitrary size to digital data of fixed size, with slight differences in input data producing very big differences in output data. The values returned by a hash function are called *hashes*. A hash can be used to uniquely identify secret information, such as computer passwords, classified documentation and BTC transactions. The bitcoin protocol uses a hash function called SHA-256 (Secure Hash Algorithm), the predecessor of which was designed by the US National Security Agency (NSA).

In the case of verifying BTC transactions, the inputs for a hash function are the block of new transactions to be verified, including a reference to the previous block in the block chain, a set of new BTC transactions and a nonce. A *nonce* is a 32-bit arbitrary number used only once in a cryptographic communication and is issued in an authentication protocol, such as SHA-256, to ensure that old communications cannot be reused.

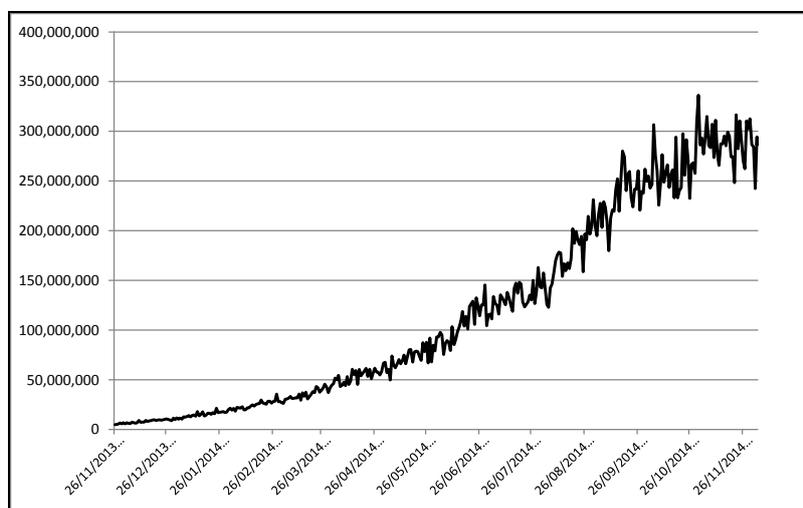
All the relevant information is *hashed up* to create a hash (the output of the function) looking something similar to this:

```
0000000000000001e8d6829a8a21adc5d38d0a473b144b6765798e61f98bd1d
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The essence of BTC mining then is trying to find the nonce (the random number) that, together with the known information on the block chain and the new BTC transactions, results in a hash that satisfies certain difficulty requirements set by the bitcoin protocol. Miners do this by trial-and-error incrementing the value of the nonce with each new attempt, e.g. starting with a nonce value of 0 and moving up.

The beauty of the protocol is that trying to find the nonce that goes with a given set of BTC transactions (in a given hash) is extremely difficult if you have only this output hash to start from. However, once the nonce is found by a BTC miner, it is very easy for other miners in the bitcoin network to verify that this nonce correctly combines with the transaction data to form the hash that everyone originally started out with. On average it will currently take approximately 172,200,000 trillion calculations, or a tremendous amount of computing power, to guess the correct nonce.

Chart 1: Combined processing power of the bitcoin network



(hash rate in GH/s)

Source: BBY Research, Blockchain.info

Why go through all this trouble?

One might ask why verifying a BTC transaction is made so difficult? The simple answer is: to deter attempts to defraud the system, for instance by people trying to spend a BTC more than once. The bitcoin protocol described above is used as a so-called proof of work system. It would take a would-be crook such huge amounts of computer processing power (and thus money) to get malicious transactions approved by all participants in the bitcoin network, that it defeats the purpose. More specifically, it would take more than 50% of the combined network processing power to defraud the system, which is pointless for individuals and most organisations because the market value of BTC would plummet if the integrity of the bitcoin system was compromised, making the entire endeavour to

defraud the system moot. It is shown³ that rational participants in the bitcoin network have no financial incentive to destabilise the network. However, organisations with ulterior motives and sufficient funding, such as governments, could theoretically be potential attackers of the system for various purposes, such as law enforcement or simply to destabilise the bitcoin system, for instance by a rogue nation.

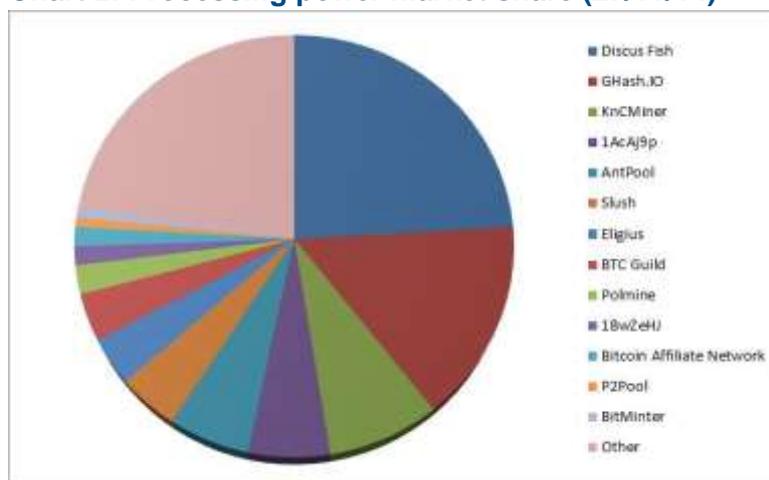
Bitcoin's Achilles' heel: the 51% attack

The bitcoin protocol operates under the rule of consensus, i.e. it stipulates that a 51% majority of the network, meaning 51% of the network's processing power, is required to make any changes to the protocol itself, for instance to how new transactions are processed or what types of transactions are accepted by the network. Therefore, any miner, or group of miners, commanding the majority of the mining processing power will be able to change the protocol.

However, even though it may not make rational sense to most network participants to change the rules of the game as this could destabilise and devalue the entire bitcoin eco system, the risk of a 51% majority being achieved is not merely theoretical. In June 2014 a mining pool called GHash.io, where individual miners combine their processing resources and share the mining revenues, reached a processing power share of 55% for a period of 12 hours. During that time, this mining pool could have changed the bitcoin protocol, effectively creating a fork in the block chain, to favour its own transactions, set transaction fees or otherwise manipulate the system. Since that time, GHash.io has implemented measures that limit the pool's processing power to a maximum of 39.99%, e.g. by not taking on new contributors if the limit is reached.

Even though the 51% rule was created to allow for bonafide alterations to the protocol to be made, we believe it is also Bitcoin's Achilles' heel. Especially since some of the mining pools are not transparent and, as indicated earlier, governmental organisations or rogue nations may gain control in this way even though it would take very substantial resources to achieve. While an actual attack may not be structurally fatal to the system, it would be highly disruptive and could significantly devalue investments in the Bitcoin eco system, including DCC's.

Chart 2: Processing power market share (27/11/14)



Source: BBY Research, Blockchain.info

The mining arms race: Speed and energy efficiency

The measuring unit of the combined processing power of the bitcoin network is called the hash rate, or calculations per second. The current hash rate of the network (see chart 1) is approaching 300 petahashes (PH), with 1 PH being 1,000 terrahashes (TH), which in turn is 1 trillion calculations per second. Given that 1 block of transactions is solved and added to the block chain approximately every ten minutes, it takes approximately $600 * 287 \text{ PH}$ (600 seconds * the current hash rate per second) = 172,200,000 trillion calculations by the entire bitcoin network to guess the correct nonce.

Given that generating revenues from BTC mining is positively correlated to how fast and efficiently a miner's computers can find nonces, it will be obvious that miners constantly require more and faster computing power that also needs to be increasingly energy efficient, which we will elaborate on later.

³ See "The economics of Bitcoin mining or, Bitcoin in the presence of adversaries", Princeton University Press, for more background on the dynamics of an attack on the bitcoin network.

In the early days (2009), BTC mining was done using ordinary PC processors (Central Processing Units or CPU's). Miners later found that the graphics processors (GPU's) inside PC's working side by side with CPU's to process the graphical data in PC's were faster and better suited to BTC mining. And so miners flocked to GPU's. However, since late 2013 BTC mining has transitioned to computer chips specifically designed for BTC mining, Application Specific Integrated Circuits (ASIC's)⁴.

Mainstream mining ASIC's currently in operation have a resolution, or line width, of 28 nanometres (nm⁵) using in excess of 0.6W per gigahash (W/GH) of electrical energy. Given that power consumption makes up approximately 60% of mining operational costs, it will be obvious that miners not only require faster chips, but power efficient chips as well.

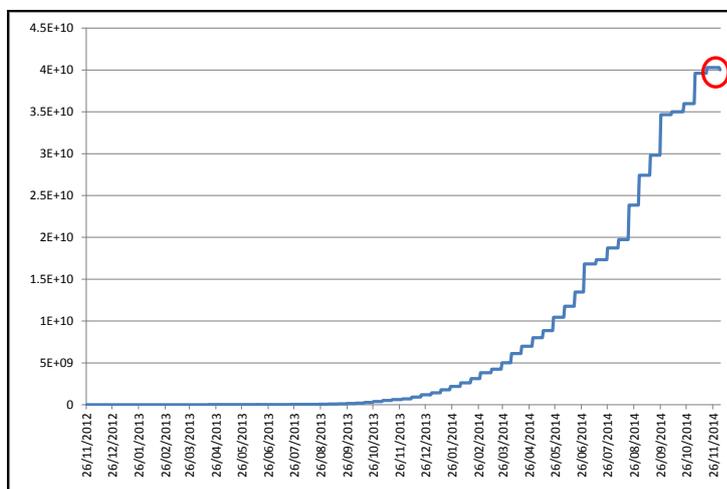
Therefore, the arms race in BTC mining revolves around the use of faster chips that use less energy than the previous generation. Mining equipment suppliers, such as Bitfury, Spondoolies, Bitmain and KnCMiner are working towards chips at a resolution of 20nm operating below 0.3W/GH.

Mining BTC becomes progressively harder over time

An obvious question one might ask is whether BTC mining will become too easy with all this increasingly fast equipment becoming available, which would lead to security issues. To counter the ever-increasing speed of computer chips, the Bitcoin protocol has a built-in mechanism that adjusts the difficulty of BTC mining every 2016 blocks mined, or approximately every 14 days, so that it will continue to take 10 minutes on average to mine 1 block going forward. So when new mining equipment comes online and mining speed goes up, the protocol will increase the difficulty level of mining at the next difficulty adjustment. This implies that the miner with the fastest equipment will have an advantage over miners with slower equipment. It has also resulted in some hardware manufacturers mining BTC with their own, newest equipment for a few weeks before actually shipping it to customers who ordered the equipment.

Generally speaking, the structural increase in difficulty we have seen since the inception of Bitcoin has risen exponentially, as illustrated in chart 3. However, the mining difficulty can also come down as we have seen early in December 2014. This was the first time in two years that the difficulty saw a downward adjustment (chart 3). It was the result of the flattening hash rate throughout November 2014, which in turn was a result of miners taking equipment offline following the relatively low BTC price, making it uneconomical for many of the inefficient players to keep equipment running.

Chart 3: Difficulty



Source: BBY Research, Blockchain.info

Mining has rapidly become a professional industry

Given that the mining reward, which we discussed earlier, has led to the emergence of dedicated and expensive BTC mining equipment, 2014 has seen BTC mining transform from predominantly an enthusiast's and hobbyist's past time into an industry that is increasingly professionally managed. The capital outlay for an efficiently run BTC mining operation will run into several millions of dollars, which leaves very limited room for individual hobbyists. Many have resorted to mining pools such as GHash.IO, Discus Fish and BTC Guild in which individual miners combine their resources and share the revenues.

⁴ Even though ASIC is a generic term used in the chip industry to describe computer chips designed with a specific application in mind, the Bitcoin industry uses the term ASIC to describe the current generation of mining chips/systems.

⁵ 1 nanometre is 1 hundredth of a micron, 1 micron is one thousandth of a millimetre. A human hair grows at approximately 31 nm per minute.

Another consequence of the professionalisation of the industry is vertical integration, i.e. miners acquiring hardware manufacturers, and hardware manufacturers moving into mining rather than merely selling mining rigs. Going forward, we would expect the number of players to decline and become more integrated than today.

Furthermore, with the stakes of the game rising, the margin for error is falling rapidly, further pushing companies to run their businesses more professionally. As an example, in recent months we have seen announcements regarding legal action against hardware manufacturers in response to product defects and delayed shipments. In our view, such issues result from the fact that the bitcoin industry is pushing the technological boundaries quite hard and not all companies can keep up with the fast pace. Similar issues are emerging in mining pools that, as an example, have become too slow in adopting cyber security measures. In other words, only professionally run organisations with adequate funding, compliance and security measures in place will be able to keep up with the transformation into a mature industry that Bitcoin is going through. In our view, DCC is one of the companies that should be able to do so, given management's prior experience and balance sheet strength.

A highly fragmented market that is moving into the cloud

In addition to the mining pools we referred to earlier, there are many unlisted, individual BTC mining companies, similar to DCC. These companies mine BTC themselves, but may also chose to commit part of their mining capacity to mining pools. In addition, given the exponential rate at which the hash rate is developing, many miners can't keep up with the arms race financially and are moving into the cloud. By doing so they can lease out mining capacity to third parties to cover part of their costs and still mine BTC for their own accounts as well. This way they will still be able to achieve the scale required to be competitive in today's BTC mining industry. Consequently, we have recently seen datacenter capacity being swooped up by BTC miners in addition to new datacenters being set up by miners themselves.

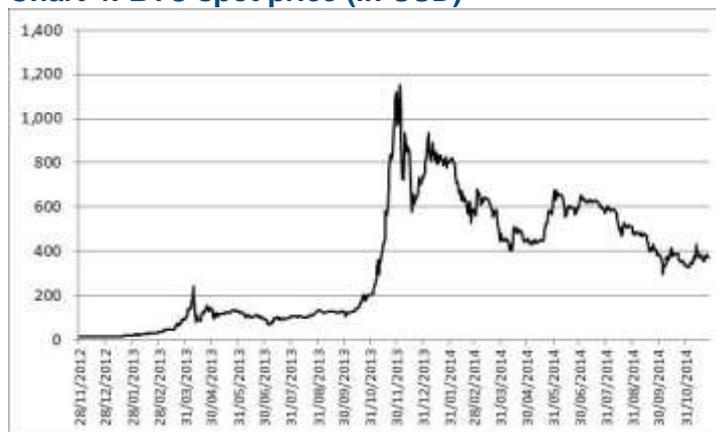
With Bitcoin going mainstream, the price should increase

In the past twelve months we have not only seen a professionalisation of the BTC mining industry, but also increasing adoption of BTC as a method of payment by large, mainstream companies. Companies like Expedia.com, PayPal, Subway, Victoria's Secret, CVS, Target, Home Depot, Sears and Dell all accept BTC as payment and the list of companies is growing very fast.

In addition, increasing numbers of BTC ATM's, trading platforms and digital wallets are making it much easier for consumers to actually use BTC in everyday life, which will further push adoption of BTC. For practical purposes, one BTC can be divided down to eight decimal places, i.e. BTC 0.00000001, just like a dollar can be divided into quarters, dimes and cents.

The Bitcoin protocol has been designed such that only 21 million BTC will ever be created. This is achieved by reducing the reward that BTC miners receive every 216,000 blocks, or approximately every four years. The next so-called *halving* of the BTC mining reward will happen in early 2016. The current total number of BTC mined is approximately 13.56m, worth USD 5.1bn at the current market price.

Chart 4: BTC spot price (in USD)



Source: BBY Research, Blockchain.info

As a consequence of this finite supply, BTC is deflationary in nature as opposed to fiat currencies that are printed by central banks to accommodate economic growth. Furthermore, as adoption of BTC by consumers and companies increases, so will demand for BTC. In turn this should drive up the price of

BTC, measured for instance in USD, if the laws of supply and demand in BTC trading hold. While DCC anticipates an increase in the BTC price going forward, we have used the BTC spot price of USD 380 in our forecasts for the company.

Making money from BTC mining: The dynamics

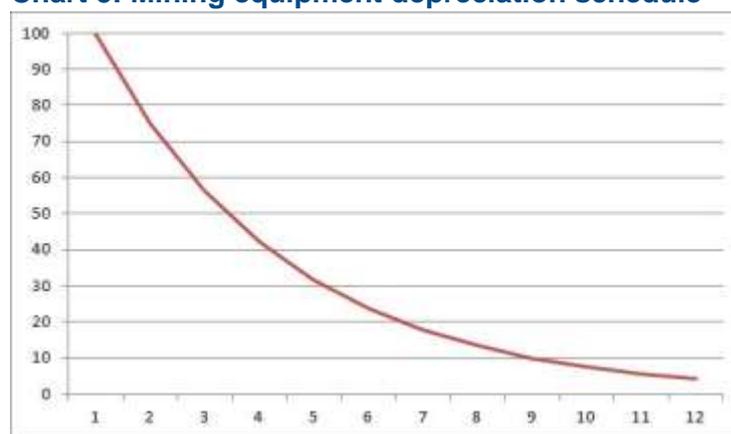
The mining business model depends on a number of key variables:

- ◆ **The price of BTC:** Obviously the market price of BTC is highly important as this determines the value of the company's mining output. However, the BTC price is extremely volatile, which complicates DCC's business planning. For instance, with the current price around USD 380 it may not make sense to keep certain, older, relatively inefficient and largely depreciated mining equipment running, whereas this would have made perfect sense in the June through August timeframe when BTC was trading between USD 500 and USD 640. Additionally, at current price levels, DCC may decide not to sell mined bitcoins, but instead hold on to them in anticipation of higher prices.
- ◆ **The price of electrical power:** With approximately 60% of direct mining costs being attributable to electrical power, it is easy to see that securing electrical power at the right price is critical in running a profitable mining operation. The first generation ASICs introduced toward the end of 2013 used 1.24 watts per gigahash (W/GH), with the second and third generation (currently in operation) using 0.8W/GH and 0.6W/GH respectively. The fourth generation ASICs, which should see commercial deployment towards the end of Q1 2015, will use approximately 0.2W/GH.

While these improvements in energy efficiency are quite substantial, sensible BTC miners will still seek out the geographies with the lowest energy costs. Iceland, with its cheap renewable energy, has been a preferred location for many miners in 2014 as have the Republic of Georgia and Inner Mongolia. However, DCC is in discussions to use and set up datacenters in other locations, such as the North Western part of the United States and Canada where power prices are even lower than in Iceland. Clearly, operational flexibility is essential if a miner is to take full advantage of global cost dynamics in electrical power, especially since the required amounts of power to run an efficient mining operation may not always be available in one specific location.

- ◆ **Mining equipment costs and depreciation:** Given the current hash rate of 270 PH/s, installing a 1% share of global mining processing power (i.e. 2.7 PH/s) will cost approximately US\$1.8m in equipment⁶. DCC depreciates this equipment at a rate of 25% of the remaining fixed asset value per month. In other words, at the beginning of the ninth month of operation, the equipment is depreciated down to 10% of the purchase price and is largely depreciated after twelve months. The equipment typically has a payback time of three to four months.

Chart 5: Mining equipment depreciation schedule



Depreciation in months

Source: BBY Research

Depending on the BTC price, energy costs and difficulty, the economic life of mining rigs is limited to six to nine months. At that point DCC may decide to decommission the rigs and sell them or lease the rigs out to third parties in three or six month operating lease contracts. DCC aims to

⁶ Using Spondoolies Yukon SP35, which is currently one of the fastest mining rigs on the market, as an example: 182 mining rigs operating at 5.5 TH/s at USD 3,595 each.

generate revenues from leasing out older equipment approximately equal to the company's depreciation level. In our modelling we have assumed DCC will be able to achieve 75% of this level. Additionally, we assume the depreciated equipment will mostly be used in lease contracts rather than be sold. Therefore, we will treat gains on sales of equipment as ad hoc one-off windfalls, i.e. not modelled.

- ◆ **Technological development, funding, chip production capacity:** The next step change in mining technology should be the fourth generation ASICs with resolutions of 20 nm or lower, operating at or below 0.3W/GH. Commercial availability is expected late in the first quarter of 2015. However, whether this equipment will actually see large scale deployment by then will depend on available funding on the part of miners. Many still have loose structures and access to capital can be erratic, i.e. miners may not always be able to invest in new equipment when it makes most economic sense to do so.

In addition, availability of production capacity on the part of chip producers further determines when new generation ASICs see the light of day. Most or all production of ASICs for BTC mining is done by chip foundries, which are leading edge chip manufacturers based in Taiwan, Korea and China that produce semiconductors for customers that do not own chip plants themselves, such as Apple and Qualcomm. For foundries, manufacturing chips used in Bitcoin mining is not high on the priority list.

To illustrate, imagine the current processing capacity of the entire bitcoin network needed to be replaced by the most advanced chip on the market today. This would require a chip foundry to run a batch of just 10,000 wafers⁷ approximately to produce the required 1.5 million chips. While this amount of IC's represents the world to BTC miners, it is a mere drop in the ocean in the grander scheme of things where production of IC's for smart phones, tablets, phablets, laptops, cars, TV's etc is vastly more important to foundries. In other words, even when design and testing of the new generation ASICs is completed in early 2015, availability will likely be limited initially due to relatively low priority for foundries to manufacture them.

All these moving parts in BTC mining and their interaction, make for a challenging environment in which to operate. DCC's investment decisions need to incorporate this complex set of dynamics. With diminishing returns on BTC mining going forward as a result of the halving of the mining reward every four years, DCC is looking to diversify into other areas such as liquidity providing, trading facilitation and BTC payment systems.



Development of B2B and B2C applications

Due to the halving of the mining reward in Q1 2016, we anticipate DCC's income from mining to fall from an anticipated US\$13m in FY15 to approximately US\$6m by FY20 (see chart 5), assuming an approximate mining market share of 2.4% throughout the period and a BTC price equal to today's spot price. As indicated earlier, DCC expects a rising BTC price, which would increase projected mining revenues in future years. However, the fact is that the mining reward will decline from 25 BTC today to 12.5 BTC after the halving, regardless of the BTC price. To cope with this decline and to reduce future operating risk, DCC is diversifying into other sources of revenues.

⁷ Assuming 270 PH/s can be achieved using 1.47 million 28 nm IC's manufactured on 300mm wafers each holding 148 IC's of 20mm x 20mm.

digitalX Direct: liquidity provision

DCC is providing liquidity of BTC to the market for a 2-3% fee by leveraging its own stock of mined BTC that have not been sold. Customers include professional investors, such as hedge funds and mutual funds. digitalX Direct has only been operational for several months, but BTC trading volume has grown rapidly. Longer term we consider digitalX Direct to be one of DCC's two main revenue sources (see chart 5).

Income from leases

DCC aims to monetise on the residual value of (partially) written off mining equipment by leasing it to third parties directly as well as through digitalX Mintsy. DCC aims to generate revenues from leases equal to the amount of depreciation. In our forecasting we have assumed the company will be able to achieve 75% of that amount.

Chart 5: Development of various revenue sources

<i>in US\$ m</i>	2015F	2016F	2017F	2018F	2019F	2020F
Bitcoin Mining	13.0	12.5	8.8	8.8	8.8	6.1
Income from digitalX Direct	0.8	2.9	3.6	4.5	5.6	7.0
Income from leases	3.6	6.7	4.5	4.4	5.4	4.3
Income from digitalX Mintsy and Pocket	0.2	0.6	1.8	3.6	6.3	9.5
Total revenues	17.6	22.7	18.6	21.3	26.1	26.9

Source: BBY Research

digitalX Pocket: a digitalBTC wallet

In order to speed up adoption of Bitcoin as a payment system, DCC will launch digitalX Pocket in early 2015. digitalX Pocket is a BTC wallet that will provide consumers with a simpler and more secure way to pay for online purchases with BTC. Additionally, it will enable instant funds transfer and cross border payments. Revenues for DCC are generated through a spread of 2% to 3%.

digitalX Mintsy: a trading platform for mining rigs and lease contracts

In a 50/50 joint venture with Cryptsy, a trading platform for crypto currencies, DCC will shortly be launching digitalX Mintsy, which is a platform for customers to lease mining equipment from DCC, offer their own equipment to be leased and trade mining contracts (leases). The actual mining equipment to be leased out will be sourced from DCC's own (partially) written off mining rigs.

With mining revenues losing significance on the back of the reward halving every four years, we expect digitalX Mintsy to be one of the main revenue drivers in the medium term. In addition, digitalX Mintsy is DCC's primary outlet for used mining rigs and as such provides a valuable way to monetise on the largely written off equipment.

Revenue streams related to digitalX Mintsy will be two-fold. Firstly, DCC will receive revenues from selling mining equipment to Mintsy. Secondly, all Mintsy revenues will be split on a 50/50 basis between DCC and Cryptsy. Hence the importance of digitalX Mintsy for DCC going forward.

The longer term potential of the protocol goes beyond Bitcoin

In recent years, Bitcoin has already proved very useful as an alternative to fiat currency, such as when people wanted different ways to get their money out of potentially grid-locked European economies. The March 2013 situation in Cyprus, when account holders were unable to access their money from one day to the next, served as an example for people in Greece, Spain, Portugal etc. and fuelled adoption of Bitcoin to circumvent established financial systems. In another example, circumvention of capital restrictions drove Bitcoin's surging popularity in China in November 2013.

While we believe that increased regulation will lead to increased confidence in Bitcoin by consumers, and thus a higher adoption rate, the possibility to circumvent certain government-imposed restrictions and regulations using Bitcoin will likely drive adoption of Bitcoin in the near to medium term.

Longer term, we believe Bitcoin as a digital currency is just one application of the block chain protocol. In our view, the protocol might be used as an alternative for any sort of trade that requires a ledger of ownership, especially if it involves high volumes and high frequency, such as options and stock trading. Therefore, we believe that future applications of the protocol will include exchanges of financial instruments, e.g. where stocks are bought and sold directly between investors without intermediation by brokers or banks. Additionally, monitoring ownership and exchange of physical assets, such as houses and cars, can also be facilitated by such a protocol.

Going forward, we would expect DCC to venture out into areas unrelated to Bitcoin, i.e. beyond the digitalX applications currently being developed by DCC, but where knowledge and expertise of the protocol is required, e.g. insurance policies, financial instruments, digital media titles, crowd funding, shared ownership etc. We have not included any such venture into our model.

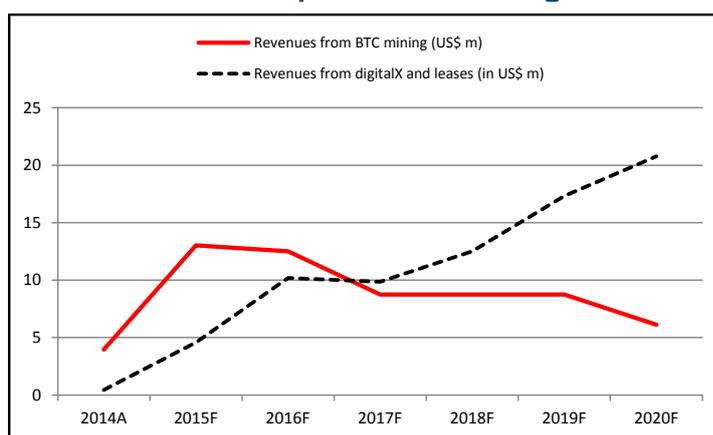
Regulation is welcomed by the Bitcoin industry

While traditional financial services companies typically prefer less regulation, the Bitcoin industry welcomes regulation as it will help build trust, credibility and legitimacy with the broader public. In turn this will help adoption of BTC as a method of payment and should drive investment in the sector. One of the first steps would be to earmark BTC as a currency, or private money, meaning people who hold BTC are not liable for capital gains tax or VAT, which is now the situation in the United Kingdom, which is well ahead of other countries in this respect. Furthermore, measures aimed at things such as anti-money laundering and background checks for directors in this industry will help drive credibility and adoption further. We expect industry regulation may be slow, but will definitely be established in the next few years, driven by Bitcoin advocates and the Bitcoin industry itself.

Modelling DCC: Less dependent on mining going forward

With the ramp up of the various applications and services in the near to medium term and revenues from leases already contributing in the current fiscal year, we expect DCC will see its revenues from these new activities exceed revenues from BTC mining beyond FY17 (see chart 6). In other words, while mining will still contribute to revenues longer term, DCC will become more diversified and should see its risk profile improve over time.

Chart 6: DCC less dependent on mining from FY17



Source: BBY Research

Even if at some point in the future DCC decides that its mining market share, which stands at approximately 2.4% per the end of 2014, should be increased by higher capex on mining equipment, we will still see the company becoming less dependent on BTC mining given increasing revenue contributions from other activities. Consequently, we see DCC developing into a technology-driven, diversified financial services company with increasingly less risk on its own "books" going forward.

Following from the declining mining revenues from FY17 onwards, we have modelled a decline in EBITDA in FY17 as well. EBITDA will recover beyond FY17 with the growing revenues from other activities. Our long term EBITDA-margin forecast is 60%+. Free cash flow will spike in FY17 as a result of assumed lower capex on mining equipment following from the halving of the mining reward in 2016.

Chart 7: Financial forecasts

	2014F	2015F	2016F	2017F	2018F	2019F
Revenues	4.4	17.6	22.7	18.6	21.3	26.1
EBITDA	2.0	11.1	16.5	11.9	14.2	18.5
EBITDA %	44.7%	62.9%	72.7%	64.0%	67.0%	71.0%
EBIT	0.14	3.91	7.52	5.93	8.32	11.27
NPAT	-11.2	2.8	5.4	4.4	6.2	8.3
Free Cash Flow	-12.0	0.3	3.8	6.5	3.7	5.1

Source: BBY Research

Valuation

When valuing DCC using relative valuation multiples, several elements need to be taken into account because the company operates in a newly emerging industry with uncommon characteristics. Firstly, most investors are unfamiliar with Bitcoin and may find it difficult to attribute a value to the company. We believe this is why the current valuation is relatively low for a high growth company.

Secondly, our projections for DCC assume a decline in mining revenues as a result of the halving in 2016. In our model the decline in mining revenues is not fully compensated by revenues from other activities until FY19. Therefore, some valuation multiples move counter intuitively in 2017.

Thirdly, given the low market capitalisation of approximately A\$ 25m currently, EV/EBITDA multiples become small and turn negative as the company has no debt and a strong free cash flow each year.

As a consequence, the usefulness of DCC's valuation multiples is limited, in our view, and we prefer to use DCF to value the company. Purely as a reference, a payments peer like Western Union trades at 8x EV/EBITDA, 9x P/CF and 12x P/E (all based on FY15 consensus estimates). It should be noted, however, that Western Union operates in a mature market with revenues of more than USD 5.5bn, while DCC is a newly established company without track record in an emerging industry. I.e. comparing these multiples is of little added value, in our view.

Chart 8: Relative valuation

	2015F	2016F	2017F	2018F	2019F
P/E	9.2	4.8	5.9	4.2	3.1
P/B	1.58	1.18	1.00	0.79	0.62
P/CF	1.71	1.59	2.18	1.96	1.53
EV / EBITDA	1.09	0.46	0.25	-0.17	-0.56
Free cash flow yield	1.4%	16.4%	27.8%	15.6%	22.0%
ROIC	25.6%	40.1%	28.5%	47.7%	54.8%

Source: BBY Research

A blue skies DCF valuation ...

Companies active in newly emerging industries, like Bitcoin, carry the promise of high, but uncertain, returns, which affects valuation levels. In a blue skies DCF valuation we would use the average ROIC at the end of the implicit forecast period (2018-2020) of 53% and a long term growth rate of 6% to arrive at our terminal value for DCC. Doing so would yield a value of A\$ 0.99 per share on current estimates.

... versus a risk-adjusted DCF valuation

However, we have been conservative in a number of aspects to reflect execution risk and uncertainties surrounding Bitcoin going forward. While ROIC in our model towards the end of the forecast period is expected to be well in excess of 50% as the non-mining business ramps up, we have capped ROIC in our terminal value at 10.3%, i.e. similar to the cost of capital implying that DCC will not be able to create value beyond the forecast period due to competitive forces and maturing of the industry. Additionally, we have used a long term growth rate of 3%, which is more in line with empirical evidence of long term economic growth as well as theoretical DCF models. These inputs lead to a DCF valuation of A\$ 0.54 per share, which we believe is more prudent at this stage.

Chart 9: DCF valuation

Explicit forecast years	PV FCF
2015	0.3
2016	3.2
2017	4.8
2018	2.5
2019	3.1
2020	5.0
Continuing value	51.3
Operating value before adjustment	70.2
Mid-year adjustment factor	1.1
Operating value	76.8
Less: MV debt	0.0
Equity value	76.8
Number of shares	168.8
Value per share in USD	0.45
Value per share in AUD	0.54

Source: BBY Research

Key upside risks to our model

We realise we are likely to underestimate the long term value of DCC operating in the nascent, fast growing, Bitcoin industry when we adjust the valuation for execution risk and medium term uncertainties around Bitcoin. The main upside risk to our model relates to a substantial upward move in the BTC price as we have assumed a flat BTC price going forward. If indeed the price of BTC moves up substantially, as DCC management expects, our projections will turn out to be too low.

Additionally, we have been conservative in forecasting non-mining, digitalX-related revenues given uncertainties around the uptake by customers, especially regarding Mintsy and Pocket.

Furthermore, if DCC is able to mitigate revenue declines resulting from the halving of the mining reward in 2016, e.g. by substantially increasing capex on mining equipment from mid-2016 onwards, our currently projected mining revenues will prove to be too low.

Finally, Bitcoin is just the first application of the block chain technology that has gained global traction so far. Going forward, we expect further development of the technology will lead to many new applications unrelated to Bitcoin. In our view, DCC is well positioned to play a role in this space, which should result in new revenue opportunities we are currently unable to forecast.

Conclusion

In our view, DCC provides an excellent opportunity for investors to gain exposure to the fast growing Bitcoin industry, both BTC mining and diversified BTC services. Longer term, new revenue opportunities based on the block chain technology will likely present themselves. Purely based on current and near-term activities we value DCC at A\$ 0.54. We initiate our coverage of DCC with a **BUY** recommendation.

Management

Zhenya Tsvetnenko (Founder and Chairman)

Zhenya Tsvetnenko is a software engineer who pioneered SMS gateway technology to market premium mobile messaging services. At 25 he started developing and programming SMS gateway technology and mastered Google AdWords. Starting with an advertising spend of A\$ 200 per month in 2006, his business grew to result in a A\$ 2 million advertising spend per month within 18 months with no external investments. Mr. Tsvetnenko founded digitalBTC and will remain active as Chairman of the Board providing overall strategy and new product development.

Alex Karis (CEO)

Alex Karis earned his bachelor's degree in marketing at the University of Massachusetts, Amherst, after which he built career in the telecommunication industry in New York providing network consulting services for network architecture. Later on he started marketing firm Karis Marketing Group ("KMG"). KMG began as a telemarketing firm providing clients and political campaigns with marketing support services. Today, KMG provides telemarketing services for the top two largest telecommunication companies in the US.

William Brindise (CIO)

William Brindise earned a degree in Business and Finance from Boston University in 1998. After graduation, he worked on the NYMEX trading floor in the energy options pit. Over the next 5 years, he traded energy options, coffee options and options on precious metals. He started his own brokerage/trading company "BAK" trading Crude Oil, Unleaded Gasoline, Heating Oil and Natural Gas. Later on he traded for a hedge fund, prop trading desks and as an individual managing his own money.

Mark Laybourn (CFO)

Mark Laybourn has significant experience in investment banking, valuations, due diligence, accounting and auditing. Mr. Laybourn was previously an Associate Director in the Corporate Finance team at Euroz Securities Limited where he gained experience working with listed companies across multiple sectors including technology. Prior to this he was a Manager with Deloitte's Corporate Finance and Assurance & Advisory teams. Mr. Laybourn is a Chartered Accountant and holds a Bachelor of Commerce (Accounting and Information Systems) from Curtin University and Graduate Diploma of Applied Finance and Investment from the Financial Services Institute of Australia.

Fabricio Rodriguez (CTO)

Fabricio Rodriguez holds a Bachelor of Science degree in Mechanical Engineering from MIT. After

graduation, he started one of the first full service web development firms and worked with many Fortune 500 companies and start-ups. As CTO of Online Environs (OEI) he was responsible for leading the technology team to build websites and applications for a variety of companies. Prior to digitalBTC, Mr. Rodriguez has worked with Karis Marketing Group (KMG) developing home grown premium mobile campaigns.



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