

Pivoting up the value chain

DC Two (ASX:DC2) is a Perth-based data hosting infrastructure service provider offering cloud-computing services through tiered colocation space. It currently has four data centres in Western Australia – Bibra Lake, Osborne Park, Darwin and Mid-West WA. In 3Q22 the company reported 19% overall revenue growth to \$905k, but what really matters is the ~27% q/q recurring revenue growth (~A\$884k) making it the fifth consecutive quarter of recurring revenue growth. We believe this consistently high growth in recurring revenue is an encouraging development and is a testimonial to the growth potential of the Australian data centre market and DC2's strong positioning in this market. DC2's modular solutions, integrated offerings and use of renewable energy are highly appreciated by its customer base and allows the company to position itself as a premium and full-service offering.

Getting into crypto mining

In early May, DC2 announced an expansion of its operations by entering the cryptocurrency sector. It unveiled plans to purchase, install and run equipment to mine bitcoin and other cryptocurrencies at Bibra Lake and will investigate the commercial viability of mining cryptocurrency via a low-capital intensity project. The company remains focussed and committed to its data centre offering but anticipates that these plans can provide new revenue opportunities.

Valuation range of A\$0.47–0.80 per share

We value DC2 at A\$0.47 per share base case and A\$0.80 per share optimistic case. We remain optimistic on the growth trajectory of the company underpinned by traction from existing and upcoming data centres. Execution is the main risk to our investment thesis.

Year to June (AUD)	2020A	2021A	2022f	2023f	2024f
Sales (mn)	1.86	1.74	2.84	5.38	9.37
EBITDA (mn)	0.01	(3.11)	(2.16)	(1.42)	1.17
Net Profit (mn)	(0.21)	(3.56)	(2.96)	(2.02)	0.30
EBITDA Margin (%)	0.8%	NM	NM	NM	10.2%
ROA (%)	NM	NM	NM	NM	1.5%
Net Gearing (%)	61.9%	32.9%	73.5%	100.5%	27.8%
EPS	(0.12)	(0.07)	(0.04)	(0.02)	0.00
DPS	NM	NM	NM	NM	NM
EV/Sales		4.0x	4.5x	2.6x	1.5x
EV/EBITDA		NM	NM	NM	11.7x
P/E		NM	NM	NM	43.2x

Source: Company, Pitt Street Research

Share Price: A\$0.062

ASX: DC2

Sector: Technology

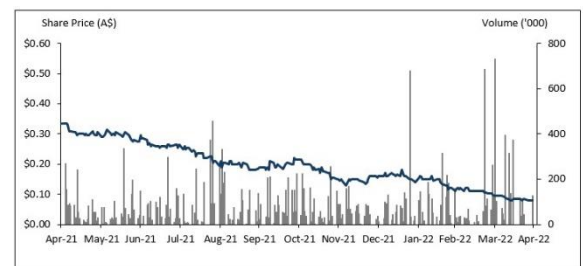
20 May 2022

Market cap. (A\$ m)	4.8
# shares outstanding (m)	75.2
# shares fully diluted (m) ¹	159.18
Market cap full. dil. (A\$ m)	9.9
Free float	55.8%
52-week high/low (A\$)	0.37 / 0.075
Avg. 12M daily volume ('1000)	85.9
Website	www.dctwo.com.au

Source: Company, Pitt Street Research

¹ See Appendix II on page 7

Share price (A\$) and avg. daily volume (k, r.h.s.)



Source: Refinitiv Eikon, Pitt Street Research

Valuation metrics	
DCF valuation range (A\$)	0.57–1.01
Relative valuation range (A\$)	0.37–0.60
Blended valuation range (A\$)	0.47–0.80

Source: Pitt Street Research

Analyst: Marc Kennis, Nick Sundich

Tel: +61 (0) 434 838 134

Marc.Kennis@pittstreetresearch.com



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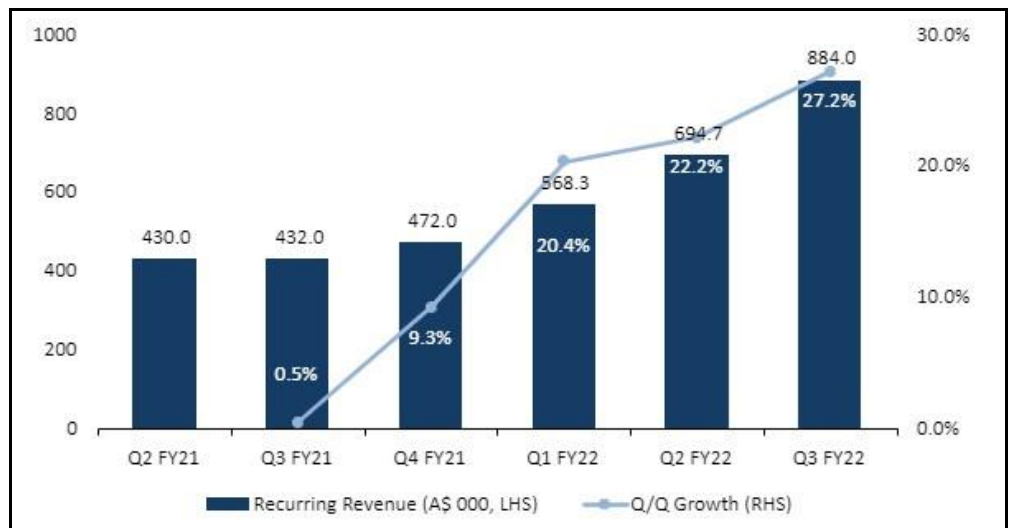
Strong recurring revenue growth in recent quarters

DC2 reported ~A\$905k revenue in 3Q22 of which recurring revenue was ~A\$884k. This represented ~27% q/q growth and is the fifth consecutive quarter of recurring revenue growth (Figure 1). The company's results have been driven by new Bibra Lake customers as well as initial sales recognised from long-term agreements for DC2's regional data centres.

DC2 has a loyal customer base that has signed fixed-term agreements with the company, providing it strong revenue visibility. In August 2021, DC2 signed a 3-year fixed-term agreement for ~A\$1.8m and in June 2021, it secured a 5-year fixed-term agreement for ~A\$926k. We expect the strong growth trajectory to continue in the near future with the company deploying sales executives to target medium and large enterprises for its Bibra Lake facility.

Strong growth driven by new Bibra Lake customers as well as demand for regional data centers

Figure 1: DC2's growing recurring revenue base



Source: Company

Close to Tier III design accreditation for Bibra Lake

The company expects to receive Tier III design accreditation for the Bibra Lake data centre in CY2022. It submitted all documentation for the accreditation to the Uptime Institute in early December 2021. Tier III certification will validate the company's claim that the Bibra Lake facility meets one of the highest standards for infrastructure functionality and capacity.

If successful, DC2 will become the only provider in Western Australia with its own Tier III accredited data centre and ISO 27001 ISMS accredited cloud platform. We believe that receiving this certification will be a catalyst for the company as it will provide it a strong edge in engaging with relatively high-budget enterprises.

Further, in February 2022, DC2 achieved VMware Cloud Verified status. This designation indicates that the company offers the complete VMware-based software defined data centre infrastructure delivered as a service. It is an important development for DC2 as this designation will provide its customers the confidence that its services are based on advanced cloud technologies.

DC2 has the potential to become the only company in Western Australia with its own ISO 27001 and Tier III accreditation



Mid-West regional data centre commissioned and capacity sold

On 17 February 2022, DC2 announced that its Mid-West regional data centre (three hours north of Perth) was fully commissioned with a maximum capacity of 2MW. This site utilises in-house developed modular data centres that are deployed at a wind farm, thereby allowing DC2 to provide eco-friendly and lower-cost services to its customers.

Just six weeks later, on 31 March, DC2 announced it sold the entire 2MW capacity. With this development, DC2 achieved its key objective behind the capital raise in September 2021 and an enhanced capacity to serve future customers. The company has estimated the full 2MW of customer equipment will translate into approximately \$2.4m of recurring revenue per year.

DC2 is also progressing well on the commissioning of an additional regional data centre project, with an estimated capacity of 1.4MW at a biogas facility in Victoria which is expected to come online in H2 CY2022. Once this project is online and revenue generating the company is expected to look at additional sites.

Pipeline of an additional data centre projects with combined capacity of 1.4MW

Strategic alliance with Attained

The company signed a strategic alliance with Attained Group, one of Perth's leading managed service providers. The alliance will result in Attained and DC2 cross selling each other's products and services, thereby allowing DC2 to offer additional professional services. Currently, DC2 is limited to offering customers certain infrastructure and security solutions, but the deal allows DC2 to be a full service offering to clients by selling managed support, internet and voice solutions, cyber security, Microsoft 365 services and additional project consultancy services required by SMEs, enterprise, and government. This alliance is for an initial six-month period.

DC2 getting into crypto mining

On 2 May 2022, DC2 unveiled plans to enter the cryptocurrency sector as part of a low-capital intensity project, which aims to investigate the commercial viability of mining bitcoin and other cryptocurrencies at Bibra Lake. The company believes this sector is complementary to its core business and its data centres already host many customers who mine bitcoin and other cryptocurrencies with specialised and high-energy computer servers and systems.

The company plans to purchase mining equipment that will be installed at Bibra Lake at a purchase cost of \$250,000. It plans to commission this equipment in 2HCY22 with the goal of understanding revenue metrics, capital expenditure and the potential to scale mining operations in the future. DC2 will decide on whether to proceed with a larger scale operation once it is operational and producing consistent data.

The company has said its corporate and commercial focus will remain on securing customers for Bibra Lake. But this strategy could open up future markets and revenues for the company. For the time being, the project will only require limited additional technical resourcing and will be enabled with a financing facility that is already in place. The company does not intend to maintain any holdings of cryptocurrency – it will convert or sell any earnings back to AUD.

DC2 believes cryptocurrency mining is highly complementary to its existing operations



A capital raising and corporate changes

DC2 also received firm commitments for a \$1.75m capital raising by way of a convertible note offering. These convertible notes will convert into ordinary shares at the higher of \$0.05 or a 20% discount to the 20-day VWAP over the 20 consecutive trading days immediately prior to conversion, subject to a maximum conversion price of \$0.15. The \$1.75m includes the conversion of existing director loans of \$361k, subject to shareholder approval.

And effective 1 July 2022, DC2 has appointed Executive Director Mr Blake Burton to Managing Director. As part of this transition, DC2's current Managing Director, Mr. Justin Thomas, will become Chief Technology Officer.

Valuation: DC2 has significant upside potential

We value DC2 in a range of A\$0.47–0.80 for DC2, using a composite of DCF and relative valuation, with equal weights.

Given that DC2 faces challenge from both domestic and international players, we have considered companies from all economies for our relative valuation (Figure 2).

Figure 2: Peer Multiples[^]

Company Name	Ticker	Last reported fiscal	M-Cap (A\$ m)	EV / Sales			
				2022	2023F	2024F	2025F
Next DC	NXT.AX	Jun-21	5,192.7	19.0x	16.1x	13.4x	13.4x
Maquarie	MAQ.AX	Jun-21	1,315.1	4.1x	3.1x	3.9x	3.7x
Aussie Broadband	ABB.AX	Jun-21	979.0	1.6x	1.0x	0.9x	0.9x
Telstra	TLS.AX	Jun-21	45,864.7	2.8x	2.7x	2.7x	2.7x
Equinix Ltd	EQIX.O	Dec-21	83,016.4	9.8x	9.0x	8.4x	7.6x
Average			27,274	7.4x	6.4x	5.8x	5.7x
Median			5,193	4.1x	3.1x	3.9x	3.7x

Note: [^]As of 20 May 2022

Source: Refinitiv Eikon, Pitt Street Research

We believe DC2 has substantial upside potential driven by effective scaling of the Bibra Lake facility and expansion of modular data centre operations. This is evident from our base case and bull case valuation (Figure 3). Considering the company's crypto aspirations are at an early stage, we have not yet ascribed any value. But if the company can prove the commercial viability, there could be further upside.

Figure 3: Weighted average valuation: Base case

Base Case	Weights (%)	Share price (A\$)
DCF	50.0%	0.57
Relative Valuation	50.0%	0.37
Composite Value		0.47
Current Price		0.08
Upside/Downside (%)		498.7%

Bull case

Bull Case	Weights (%)	Share price (A\$)
DCF	50.0%	1.01
Relative Valuation	50.0%	0.60
Composite Value		0.80
Current Price		0.08
Upside/Downside (%)		931.9%

Source: Pitt Street Research



Re-rating DC2

DC2's stock is currently trading below our base case valuation. We see four catalysts to re-rate DC2 into our valuation range:

- Success in achieving Tier III accreditation for the Bibra Lake facility;
- Swift expansion of modular data centre portfolio;
- Increased bundling of cloud and hosting services through related industry players;
- Commercialisation and swift deployment of software platform.

Risks

The main risks to our investment thesis include:

- **Execution risk:** The majority of the future growth for DC2 is expected to come from the newly operationalised Bibra Lake facility and higher traction within modular data centres. Any interruption in expansion of modular centre portfolio and delay in receiving Tier III accreditation for the Bibra Lake facility might jeopardise investor sentiments.
- **Economic downturn in focussed industry:** DC2 is expected to generate a significant portion of modular data centre revenue from crypto-miners. Considering that this is a relatively young business with reasonable risk, any downturns here can hamper DC2's growth potential.
- **Geographical concentration:** Western Australia represents 91% of the group's revenue. This may restrict the growth potential for DC2 in Western Australia as the market becomes competitive.
- **Channel partner concentration:** The majority of DC2's revenue (~60%) comes from the network of channel partners which offers referrals to the company from its customer base. However, DC2's recent efforts to increase direct sales mechanism for the new-age services should help mitigate this risk.
- **Competition:** As the Australian data centre market expands, the larger (regional and foreign) data centre and cloud-computing providers will increase presence in this region. DC2 will have to counter their financial and technological prowess to retain its market share.



Appendix I – Analyst Qualifications

Marc Kennis, lead analyst on this report, has been covering the Semiconductor sector as an analyst since 1997.

- Marc obtained an MSc in Economics from Tilburg University, Netherlands, in 1996 and a post graduate degree in investment analysis in 2001.
- Since 1996, he has worked for a variety of brokers and banks in the Netherlands, including ING and Rabobank, where his main focus has been on the Technology sector, including the Semiconductor sector.
- After moving to Sydney in 2014, he worked for several Sydney-based brokers before setting up TMT Analytics Pty Ltd, an issuer-sponsored equities research firm.
- In July 2016, with Stuart Roberts, Marc co-founded Pitt Street Research Pty Ltd, which provides issuer-sponsored research on ASX-listed companies across the entire market, including Technology companies.

Nick Sundich is an equities research analyst at Pitt Street Research.

- Nick obtained a Bachelor of Commerce/Bachelor of Arts from the University of Sydney in 2018. He has also completed the CFA Investment Foundations program.
- He joined Pitt Street Research in January 2022. Previously, he worked for over three years as a financial journalist at Stockhead.
- While at university, he worked for a handful of corporate advisory firms.

Appendix II – Capital Structure

The count of diluted shares includes the following assumptions:

- That 502.5k convertible notes (T1) are converted into fully paid ordinary shares. The issue of these securities is anticipated to be completed utilising the Company's existing capacity under ASX LR 7.1.
- That 1.2485m convertible notes (T2), 4m corporate advisory options and 4m director options, are converted into fully paid ordinary shares. The issue of these securities is subject to shareholder approval at the Company's next general meeting.
- Refer to the Company's announcement dated 2 May 2022 for further details.

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