



**DARK BLUE SEA LIMITED**  
**ACN 091 509 796**

**Company Announcement**

**Date: 4 February, 2008**

## **December 2007 - Quarterly Update**

Dark Blue Sea Ltd (ASX listing code DBS) today released an update on its quarterly performance for the three months to 31 December, 2007.

As advised with the release of the March 2006 quarterly cash flow statement, the Company will no longer lodge Appendix 4C statements with the Australian Stock Exchange. The company has previously announced some Key Performance Indicators (KPIs) coincident with these releases. It is the company's intention to continue to release these KPIs on a quarterly basis.

This release contains information about:

- Key Performance Indicators
- December Quarter Trading Performance
- Outlook for the US Online Advertising Industry
- Update on Secondary Market Domain Sales
- Financial Impact of the Australian Dollar versus the US Dollar
- First Half 2007/08 Financial Results

### **Key Performance Indicators**

The Company releases some key financial performance indicators for comparative purposes. These indicators are based on unaudited management accounts.

The updated Key Performance Indicators for the December 2007 Quarter are on the following page.



	Qtr end 31.12.06	Qtr end 31.03.07	Qtr end 30.06.07	Qtr end 30.09.07	Qtr end 31.12.07
<b>Revenue (US\$'000)</b>					
Internal Traffic – Profitable Domain Names	1,587	1,871	1,963	1,923	1,550
Internal Traffic – Unprofitable Domain Names	68	78	88	87	111
Total Internal Traffic	1,655	1,949	2,051	2,010	1,661
Internal Domain Name Sales	318	333	638	857	1,366
Total Internal Revenue	1,971	2,281	2,688	2,866	3,026
External Traffic	3,709	2,912	2,547	2,759	2,900
Total Traffic Revenue	5,362	4,859	4,597	4,768	4,561
<b>Revenue Margin (%)</b>					
Internal Traffic – Profitable Domain Names	90	90	89	88	85
Total Internal	52	59	69	68	69
External	26	28	31	27	26
Total Traffic	31	38	44	39	33
<b>Number of Profitable Domains</b>	110,000	129,000	150,000	153,000	152,000

A more detailed explanation on the Key Performance Indicators is provided in the “Background on Key Performance Indicators Section” below.



## **December Quarter Trading Performance**

The company has had a mixed trading performance in the December Quarter— a poor performance on the traffic / advertising side of the business was offset by a good outcome on domain sales.

Advertising revenue from the company's own domain name portfolio was disappointing. Revenue from the Company's domain name portfolio for the quarter was approximately US\$1.66 million, an annualized rate of approximately US\$6.6 million. This was up slightly on the corresponding quarter in 2006 but down from the approximate US\$2 million achieved in the September 2007 quarter.

Advertising revenue for the month of December was particularly weak perhaps reflecting a slowing online advertising market. A more detailed discussion on the outlook for the US online advertising market and the potential impact on the company is provided below.

Gross secondary market sales of the Company's domain names were US\$1,366,000 in the December quarter, up substantially from US\$857,000 in the June quarter. This reflected further progress made in the rollout of Domain Distribution Network ("DDN"). As previously advised, the December quarter included the proceeds from the sale of bedroomfurniture.com of more than \$250,000.

Trading in the Company's external business in the December quarter improved marginally over the September quarter. Revenues were slightly better than the September quarter but the margin achieved was lower.

## **Outlook for the US Online Advertising Industry**

Over the last quarter, the credit crisis in the US has materially worsened and there is now widespread expectation of an economic downturn in the US. Dark Blue Sea is a US centric business that generates most of its revenue from the US online advertising industry. In this regard some comments on the outlook for the US online advertising industry and the way this may impact the Company are appropriate.

Most of Dark Blue Sea's (and the domain industry generally) current revenue comes from the US online advertising industry. Direct navigation traffic is a natural fit with search / keyword based advertisers, a large segment (approximately 40%) of the overall online advertising market.

Google and Yahoo are the dominant players in search advertising together controlling most of the market. Google and Yahoo are also the ultimate sponsor of most of the direct navigation traffic, collecting most of this revenue before distributing a percentage of that revenue to domain name owners.

The online advertising industry has been growing at 25% to 30% per annum since bottoming out in 2002 and while estimates from industry analysts of future growth vary, similarly strong growth rates are anticipated for the next few years. In October 2007, eMarketer, the leading online advertising industry research group, released updated



forecasts of 28% growth for 2008 and 16% for 2009. The main macroeconomic driver of growth in the online advertising industry is the increasing amount of time that consumers are spending online versus other media such as free-to-air and cable TV and their respective ad spend. Underwritten by this shifting audience dynamic, strong growth in the online advertising industry is viewed as a secular trend.

One of the reasons that the online advertising industry's share of ad spend is still low relative to audience is that it has not yet been fully embraced by two significant advertiser segments – major brand advertisers and SMEs. Growth in the online advertising industry to date has been substantially driven by internet companies and direct marketers. Major brand advertisers are expected to be the biggest source of growth over the medium term as they start to shift their budgets from TV and other media towards the online space. Recruiting SMEs to online advertising has commenced but is a longer term challenge as it requires the mobilization of significant human resources.

Google and Yahoo have been and are expected to remain significant beneficiaries of the growth in the overall online advertising industry. Most of the commercial agreements in the direct navigation industry are prepared on the basis of revenue share with these search advertising networks. Assuming that the commercial structure of these agreements remain in place (and there is currently no reason to think otherwise), direct navigation traffic owners (including Dark Blue Sea) should continue to achieve revenue growth rates broadly in line with the growth rates in the online advertising industry.

From a practical perspective, spending advertising dollars on Google and Yahoo involves bidding into millions of real time auctions based on keywords, geographic location, ad type and a range of other factors. Like all auction based systems, prices achieved are highly dependent on number of buyers and marginal pricing. At an individual keyword level prices can be extremely volatile. High pricing for a particular keyword is typically achieved when a stable group of advertisers progressively increase their bids or when a new large advertiser enters the market. But if a few advertisers drop out of the auction for that keyword, the price can collapse as all the auction participants reassess their bids – a process that is further exacerbated by a range of automated bidding services that are currently available. There are reasonably efficient markets at work here – over a relatively short period of time the lower prices attract new advertisers or increased ad spend from existing advertisers, the auction rebuilds and prices start to increase again.

Some industry analysts are now concerned about the cyclical exposure of the online advertising industry to an economic downturn. Whilst online advertising is still one of the most cost effective methods of advertising, it is also one of the easiest to cancel. And cancelled online advertising can lead to immediate price impacts through the auction transmission mechanism outline above.



In December, the company noticed that a couple of very significant internet advertisers had scaled back their online advertising leading to a significant diminution in the price per click received from its major upstream advertising partner. A number of industry commentators have also noted that December appeared to be a poor month for the online advertising industry.

Whilst there has been some recovery in January, prices are still well below levels of three months prior. In the context of the current US economic environment, it is possible that similar shocks may occur over the coming months.

In summary, as the expected US economic slowdown unfolds, we are heading into uncharted waters. Despite the continued strong secular trend for the online advertising industry, the cyclical factors are likely to have some negative influence and, as of today, a wide range of outcomes appear possible.

### **Update on Secondary Market Domain Name Sales**

The Company continues to roll out the Domain Distribution Network (“DDN”), the Company’s secondary market domain sales business.

The Company is now live with most of the major retail registrars including GoDaddy, Network Solutions, Register.com, Tucows and Moniker. This is the key target market for the secondary market sale of domain names.

The Company continues to work on additional improvements. It is still early days and there are still a significant number of issues (optimisation, implementation and commercial) to work through but the results remain very encouraging.

Domain sales have been broadly tracking around a US\$3.5 million annualised run rate prior to abnormal sales (such as bedroomfurniture.com in the December quarter).

Going forward, most of the material improvements in domain sales are likely to come from improved systems and sales processes at the retail registrars. Whilst the Company can assist the retail registrars, the rate determining step is their forward development schedule.

More recently, the Company has been focussing on recruitment of additional domain names into the DDN. Additional domain inventory should help accelerate the overall development of the market by providing more opportunities for retail registrars to sell secondary market domain names and hence be in a better position to refine their systems.

The Company expects that tangible financial benefits from the DDN will continue to become progressively clearer over the coming quarters, with the full financial benefits expected to be realised over the next couple of years.



The magnitude of the potential growth from the DDN is still difficult to quantify but is expected to be significantly more than current levels on a trend basis.

### **Financial Impact of the Australian Dollar versus the US dollar**

The Company continues to be adversely affected by the rise in the Australian dollar versus the US dollar. Even though the company reports in Australian dollars, most of the company's business is transacted in US dollars. The effect is seen in the translation of balance sheet items and is explicitly recognised in the Profit and Loss. There is also a "through the period" effect which is not explicitly recognised but is observed as a reduction in the operating margin.

The Company's internal modelling indicates the explicitly recognised (i.e. balance sheet translation related) EBITDA sensitivity to be approximately A\$50,000 per one cent move in the Australian dollar / US dollar exchange rate. The operating margin impact of currency movements is more difficult to quantify exactly. The Company's internal modelling estimates the current sensitivity on 2007/08 EBITDA to be approximately A\$150,000 per one cent change (based on current levels of financial performance being maintained). Since June 30, 2007, the exchange rate has moved adversely by approximately five cents.

In addition to this impact, the Company expects to generate significant additional revenue (and EBITDA) from increased secondary market domain name sales over the coming financial periods. All this incremental revenue will be denominated in US dollars and will increase the currency sensitivity of the Company in absolute terms.

The Company manages the operational aspects of the business from a US dollar perspective and keeps excess cash in US dollars. The Company brings back sufficient US dollars on a regular basis to fund its future Australian dollar liabilities (overheads, tax and dividends) but doesn't actively hedge for exchange rate movements. In this regard, the Company continues to be exposed to a rising Australian dollar versus the US dollar.

### **First Half 2007/08 Financial Results**

The Company's first half 2007/08 financial results will be released in late February, 2008.

On the basis of the Company's unaudited management accounts, revenue for the first half was approximately A\$15.4 million, EBITDA was approximately A\$2.75 million and NPAT was approximately A\$1.8 million. Cash at bank was A\$5.9 million.

During the period, the Australia dollar moved adversely by approximately three cents. The explicitly recognized exchange rate loss through balance sheet translation was approximately A\$210,000 whilst the overall impact is estimated by the company to be approximately A\$600,000.



Whilst the dividend will only be formally considered after the half yearly accounts are finalised, the Company's dividend policy remains unchanged.

### **Key Performance Indicators Background Information**

The Company releases some key financial performance indicators for comparative purposes. These indicators are based on unaudited management accounts.

From an overall financial performance perspective, it is important to understand that the Company generates all its revenue in US dollars and it pays all its traffic sources in US dollars, so the Company earns a gross profit which is denominated in US dollars. However, the Company's overheads which are primarily staffing related are denominated in Australian dollars so the \$A/\$US exchange rate can have a significant impact on the Company's financial performance.

The Company generates the bulk of its revenue from selling traffic. A segmentation by traffic source provides the best indicators of the overall trends in the financial performance of the Company.

In any Internet business that generates revenue from traffic, it is important to distinguish between revenue generated from **Internal** and **External** traffic sources. **Internal** traffic sources are ones that are owned and operated by the Company. **External** traffic sources are ones that are owned by customers of the Company.

As **Internal** traffic sources are controlled by the Company they form a reliable annuity style revenue stream. **External** traffic sources are much less reliable as they are subject to competition in the traffic market. Almost all traffic arrangements can be cancelled on short notice and contracted deals rarely extend beyond one or two years.

Dark Blue Sea's **Internal** traffic is almost exclusively sourced from the Company's domain name portfolio. Dark Blue Sea's **External** traffic sources are primarily other domain name portfolio owners. The Company uses its unique platform, good relationships with domain name portfolio owners and competitive pricing as the primary methods of acquiring and maintaining **External** traffic sources.

The Company earns different margins on **Internal** and **External** traffic sources. For **Internal** traffic sources, the main expense is domain name registration fees. These are a fixed cost and so the margins can be high and expand as the industry grows. For **External** traffic sources, the arrangements are typically revenue share based and hence the margins are much lower. Good traffic sources have excellent bargaining power.

A further segmentation of the Company's **Internal** traffic sources provides additional clarity. A breakdown of the Internal Revenue into the revenue that is generated from **profitable domain names** (i.e. those domain names that earn sufficient revenue to cover the annual registration expense) and **unprofitable domain names**, the number of profitable domain names and the margin achieved on the profitable names



is provided. It should be noted that the portfolio of profitable domain names generates the bulk of the **Internal** revenue and is a very high margin business.

Domain sales revenues include revenue from all domains the Company sold during the period. These include sales from the Domain Distribution Network, the Company's main web site (FabulousDomains.com) as well as ad-hoc sales (typically for a large number of domains) that are agreed external to the web site.

It should be noted that the Company has additional revenue sources that are not included in these numbers. These revenue sources do not currently have a material impact on the overall financial performance of the Company.

### **Accounting Treatment of the Domain Name Portfolio**

For both new domain name registrations and renewals, it costs the Company US\$6.42 to hold each domain name for a period of one year. The \$US6.42 cost is paid in advance and so has an immediate cash flow impact. It is viewed by the Company as a prepayment of traffic for twelve months and is recorded as a short term asset in the balance sheet. Domain name registrations are also recorded as operational cash flow in the reported cash flow statements.

The Company amortises that US\$6.42 short term prepaid traffic asset over the subsequent 12 month period, effectively passing that cost through as an expense in the profit and loss statement.

Notwithstanding the accounting treatment of domain name registrations and renewals, the domain name portfolio is viewed by the Company as of a capital nature, ie. an enduring asset having long term revenue generating capabilities.

In regard to the Company's domain name sales, the proceeds of sales are treated as operating income, and the component in excess of the registration expense is recorded as operating profit.

### **About Dark Blue Sea**

Dark Blue Sea is an online advertising intermediary or "internet traffic" broker servicing a global customer base from its office in Brisbane. Dark Blue Sea has developed and successfully manages a number of world-class commercial Internet properties including:

- Roar and Pageseecker, pay-per-click advertising portals;
- Fabulous, an ICANN accredited domain name registrar and domain name management system;
- Dark Blue, an online advertising affiliate network;
- The Domain Distribution Network and
- Its Domain Name Portfolio.



Fabulous, Dark Blue and Roar / PageSeeker provide a fully integrated package for the generation, management and monetization of “internet traffic”. “Internet traffic” is directly analogous to shopping centre floor traffic.

The ability to offer traffic sources and advertisers a platform consisting of an integrated domain name registrar, advertiser affiliate network and a pay-per-click advertising portal is a compelling value-added proposition that the Company believes is unique in the global marketplace.

Dark Blue Sea currently owns a portfolio of more than half a million internet domain names.

The vast majority of Dark Blue Sea’s domain names are what are termed generic keyword domain names. These are domains such as [www.booksellers.com](http://www.booksellers.com) that are constructed from generic keywords or phrases (“book sellers” in this case). Users find Dark Blue Sea’s domain names by simply typing domain names such as [www.booksellers.com](http://www.booksellers.com) into the address bar of their browser (e.g. Internet Explorer).

Approximately 170,000 people (or “unique visitors”) from around the world type in (or “directly navigate” to) one of Dark Blue Sea’s domain names every day.

The “internet traffic” that is generated from Dark Blue Sea’s portfolio of domain names can be sold to online advertisers. Advertisers can purchase the “internet traffic” from either Roar / PageSeeker or Dark Blue, the Company’s online advertising properties. Dark Blue Sea also has commercial relationships with many other leading online advertiser networks that effectively also buy the “internet traffic” from Dark Blue Sea’s domain name portfolio.

Fabulous was developed to help the Company manage its own domain name portfolio and to provides services to other domain name portfolio owners. The Company combines the internet traffic from its own and other portfolios to try to negotiate the best possible advertising deals.

Fabulous also provides domain name registration services. Fabulous is currently the 14<sup>th</sup> largest domain name registrar in the world.

Domain names are the real estate of the internet – it is the first step for any business wanting to establish a presence on the Internet. Domain names can trade in the secondary market. Through the Domain Distribution Network, small businesses and individuals can purchase secondary market domain names through their preferred retail registrar.

The Company believes it is well-positioned in a small but important niche of rapidly growing global US\$20 billion per annum online advertising market as well as the emerging domain name secondary market.



Dark Blue Sea is listed on the Australian Stock Exchange (code: DBS) and has a Level 1 over-the-counter ADR program through the Bank of New York (code: DKBLY)

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