

04 April 2007

UNITED KINGDOM • Media

**BUY**

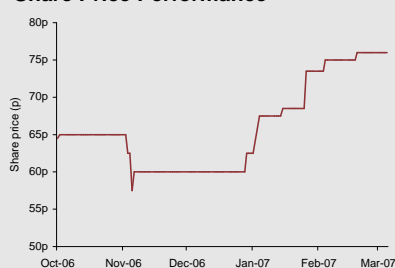
Price at 30 Mar 2007 (p) 76  
52-week range (p) 57.5 - 76

Reuter: DIGI Bloomberg: DIGI LN  
Exchange: LSE Ticker: DIGI

## Digital Marketing Group

### Marketing in the digital age

#### Share Price Performance



We initiate coverage of Digital Marketing Group (DMG) with a Buy recommendation. This view is based on three main factors: 1/ DMG enjoys the following wind of a fast growing market 2/ DMG has a clear plan and a compelling offering 3/ management has a proven track record in growing businesses. We believe that there is significant upside in the stock to be realised as evidence continues to show that DMG are delivering on their strategy.

#### Background

In October 2006, DMG was merged with an AIM investment vehicle with the intention of building a "one stop digital direct marketing group". It raised £7.8 million via an additional placing and has since purchased four businesses in its identified core areas of digital marketing, digital media, direct marketing and data services. It is important to note that DMG is not a roll-up or consolidation play. DMG's strategy is to build a "one stop offering" through a small number of selective acquisitions in complementary fields.

#### Marketing revolution

Internet commerce and communication is flourishing, so too is internet marketing spend in its wake. DMG predict that internet marketing spend will rise from 8% today to 25% of all marketing spend by 2012. Traditional marketing services groups are finding it difficult to adapt their offering as quickly as their clients are demanding. This is largely because they are understandably reluctant to cannibalise their existing traditional services with their associated large cost bases. At the same time, emerging digital marketing players operate in specific niches and do not have a full product offering. DMG have rightly identified the opportunity to selectively acquire and integrate some of these specialist digital businesses to build an integrated offering and rapidly gain market share.

#### Valuation

We expect DMG to deliver PAT of £2.7m and £3.5m for FY07 and FY08, an organic growth rate of 30%. This puts DMG on 14.1x 07 falling to 10.8x 08. What is more, our estimates are based on sales to blue chip organisations delivered by a management who have a proven track record in the delivery of such contracts. These prospects are in stark contrast to other media groups trading on Aim, who are making heavy weather of this new environment. In our view, in contrast with DMG, they are limited by one or more of the following: a limited offering, an unfocussed strategy and an over reliance on traditional marketing services. We believe that the broadly similar trading multiples between DMG and these other outfits do not reflect DMG's competitive advantage, growth prospects and profitability, and that this anomaly will not last for long.

#### Forecasts and ratios

Year End March	2005A	2006A	2007E	2008E
Revenue (£'m)	14.3	19.1	23.9	30.8
EBITA (£'m)	2.2	3.6	4.7	5.9
PBT (£'m)	2.2	3.6	3.9	5.1
EPS (p)	-	-	5.4	7.1
% Change	-	-	-	31
DPS (GBP)	-	-	-	-
Yield (%)	-	-	-	-

Source: Cenkos securities estimates, company data

Performance(%)	1m	3m	12m
Absolute	3.4	26.7	-

#### Stock Data

Market cap (£'m)	38.1
Shares outstanding (m)	50.1

#### Key Indicators

EBIT margin (%)	16%
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#### Activities

Provider of digital marketing services

#### Directors

Stephen Davidson	Chairman
Ben Langdon	CEO
Robert Millington	CFO

#### Significant Shareholders (%)

Mayfair Ltd	25.1
Gary & Helena Stevens	14.0
Martin Boddy	9.8
Andrew Gardner	9.8
Charles & Kathleen Buddery	7.7
Katherine Jerman	5.6
Jamie Riddell	5.6
Tudor Capital	3.5
Total	81.1

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## Investment case

The following pages outline the reasons behind our positive stance on Digital Marketing Group (DMG).

### Exciting market opportunity

That the internet is growing as a medium of communication and commerce is well documented. What has been less apparent is that take up has not been uniform, which has led to disparities between demand and supply of services. Just such an example is marketing over the internet. Take the UK as an example:

- 63% of the UK population are now on-line – and over 80% of these use it to source information, 63% to shop and 45% to bank on-line
- By 2010, some £60 billion, the equivalent of 20% of all retail expenditure, is forecast to be transacted over the Internet
- However, although on line advertising grew 66% during 2005 to £1.4 billion, it still only accounted for 8% of total advertising expenditure
- Growth in on-line marketing spend is anticipated to outstrip all other aspects of marketing spend over the next three years and forecast by DMG to reach 25% of marketing spend by 2012

The growth of online marketing is not only demand led. Companies have a strong incentive to switch advertising spend, as online direct marketing offers key advantages over the more traditional methods:

- It is instantly measurable, in that it allows clients to monitor behaviour and transactions, often in real time and thereby determine the effectiveness of campaigns
- It is flexible, enabling campaigns to be adapted or modified at very short notice
- Perhaps most importantly, it facilitates data capture, so advertisers can obtain a much greater degree of information about their consumers than they can through the traditional channels

In summary, online interactive marketing is growing in importance and has yet to reach its full potential. As digital marketing allows for consumer-brand interactivity, companies can learn a lot more about their clients' needs and behaviour and tailor products, services and communications according to customer data. This should ultimately result in a significant improvement in returns on marketing spend as digital marketing gives advertisers far more visible and measurable ROI. By way of a parallel, the supermarkets have been using storecards to much the same effect over the last decade, i.e. capturing data about their customers to ensure that their offering is competitive.

### Changes afoot

Corporates are fast realizing the power of the internet and switching their spending accordingly:

- Online expenditure is growing at 40% year on year against traditional advertising at 1.4% as advertisers respond to the enormous potential offered by online campaigns.
- McDonalds has doubled its online global advertising budget
- The 20 retailers in top 200 US brands boosted their online spending by a collective 152% in the first half of 2006
- Cadbury increased its digital spend ten fold on its Crème Egg brand and is set to sign a seven-figure digital investment for 2007
- Shell announced that it is spending \$100m on a global advertising campaign of which 15% is to be spent on the web (March 3rd 2007)

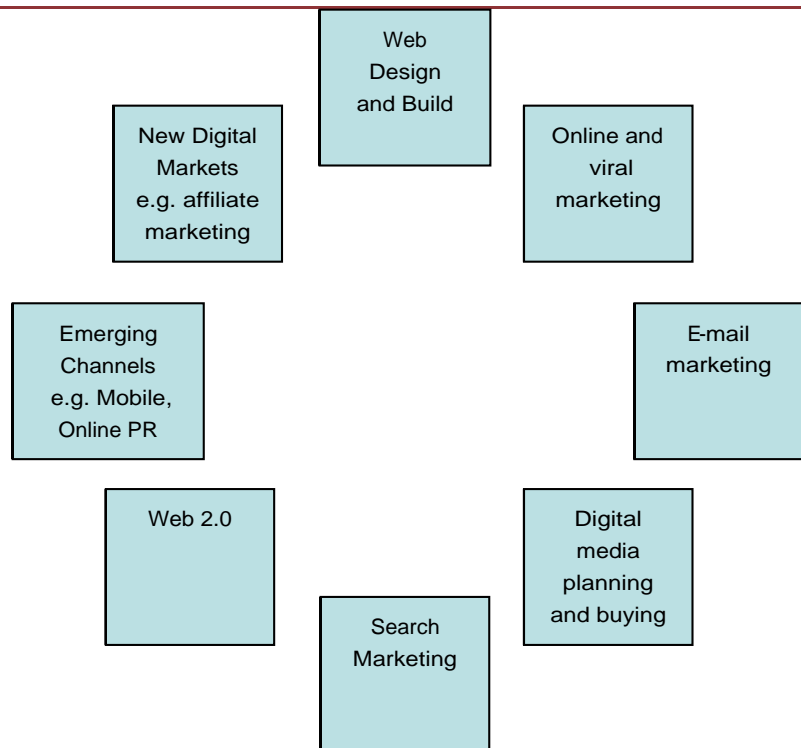
Traditional providers of marketing services are finding difficult to respond at the same pace as the market. The principal reason for this is that the larger players are reticent to cannibalise existing operations by directing clients away from their traditional business with its weighty cost base. This has allowed smaller, focused niche operators to emerge.

### Opportunity to create a “one-stop-shop”

As is so often the case with new markets, the competitive landscape has been quickly populated with disparate players which focus on specific areas. As there are many different facets to digital marketing, the industry has already become highly fragmented. However, the market has matured to such an extent that corporates are keen to embrace an offering that oversees all the elements of digital marketing.

These are summarised in the following diagram:

#### Digital Marketing Disciplines



Source: Cenkos Securities

In addition to which, the currently fragmented digital marketing industry has unsurprisingly yet to integrate itself with the direct marketing and data skills necessary to offer clients true end to end digital direct marketing .

With this opportunity in mind, DMG has acquired four well established, profitable and fast growing companies. All have proven expertise in their individual fields and experienced high quality management teams:

- HSM Ltd – one business with two divisions; Inbox Digital, an online marketing agency and HSM Telemarketing.
- Dig for Fire- the UK’s largest direct marketing agency operating exclusively outside of London.
- Cheeze-one of the UK’s leading digital media planning and buying agencies.

- Jaywing- the UKs largest independent data services company

Each offers considerable organic growth potential in its own right but can also benefit from significant incremental growth to be gained through exploiting the collective resources of the group. The following table outlines the companies bought, area of expertise and consideration paid.

#### Digital Marketing Group

Acquired Company	Date	Segment	Consideration (£m)	P/2007EBIT
HSM**	Oct'06	Digital/Direct	8.0	8.4x
Dig for Fire*	Oct'06	Direct	7.8	5.6x
Cheeze**	Jan'07	Digital	9.5	14.2x
Jaywing*	Jan'07	Data	14.5	6.3x

\*12m EBIT to Mar 07 – \*\*12m EBIT to Dec 06

Source: Cenkos Securities

### How an integrated approach may work

As a result of the acquisitions DMG can already offer clients an integrated approach involving some or all of the businesses of the group. An example of an integrated approach involving all the acquired businesses is as follows:

- Direct marketing strategy developed – Dig for Fire
- Data on prospective and existing customers gathered – Jaywing
- Telephone qualification undertaken to build profile and gather email address – HSM
- Online and viral advertising, and online media buying – Inbox / Cheeze
- Email communications programmes implemented – Inbox Digital
- Follow up by dedicated telemarketing team – HSM
- Lead tracking undertaken to monitor results and complete the sale – HSM
- Ongoing data evaluation and refinement to marketing activity – Jaywing

### Experienced management team

The DMG management have considerable experience in media and business development. Ben Langdon has been involved with all aspects of the marketing and advertising businesses and has an established track record of successful client acquisition in the agency sector. Stephen Davidson brings financial expertise from his time in the media and financial services industries and practical business skills. He has substantial experience as chairman, executive and non-executive director.

## Company profile

### Background

The DMG Group was created through the merger in October 2006, of Seashell II, an Aim listed investment vehicle controlled by Michael Ashcroft and DMG, a UK incorporated company with no trading history. The company had approximately £2.7 million in cash at the time of the merger and has subsequently made four acquisitions.

#### Digital Marketing Group (£'000)

Company	Acqu Date	Segment	Consideration	05/06Rvn	05/06EBIT	EBIT Margin
HSM	Oct 06	Digital and Direct Marketing	£8m	4,051	649	16.0%
Dig for Fire	Oct 06	Digital and Direct Marketing	£7.8m	5,138	1,228	23.9%
Cheeze	Jan 07	Digital Media	£9.5m	1,471	376	25.6%
Jaywing	Jan 07	Data Services	£14.5m	8,482	1,332	15.7%

Source: Cenkos Securities

The recent acquisitions provide the core platform of the business and future additions would be add-ons in those areas, in particular in emerging technologies such as mobile marketing and Web 2.0 or sector-specific agencies, such as business to business and media and entertainment.

### HSM

#### *The first cornerstone – a digital and direct marketing services specialist*

HSM was considered to be a cornerstone acquisition for DMG, providing both established online marketing services and specialist direct marketing services through its telemarketing division. In the year to March 2006 (adjusted), its revenues were £4.0 million, generating a pre tax profit of £649,000. The business has been acquired for a net £8 million in a 50/50 cash and shares deal. The CEO, Gary Stevens, has joined the main board of DMG.

It operates through two divisions – Inbox Digital and HSM Telemarketing (HSMT). It has achieved a high level of integration across the two divisions and this enables it to offer clients direct marketing through a number of different digital channels. At its heart is a proprietary technology platform which integrates real-time Internet, email and telephone communications, thereby allowing highly targeted and personalised campaigns with detailed reporting for telemarketing follow up.

Inbox plans, creates and manages end-to-end digital marketing campaigns for many leading blue chip companies including Vodafone, Panasonic and BMW and has recently been appointed to the European supplier list of Procter and Gamble, the world's largest purchaser of advertising services. Inbox's services include online advertising, email marketing and viral advertising, websites and campaign reporting. HSMT offers a full spectrum of telemarketing services with a broad range of value added support services such as database management. HSM currently employs 170 people.

### Dig for Fire

#### *The second cornerstone - a direct marketing agency*

Initially trading as Scope, Dig for Fire was DMG's second cornerstone acquisition. It is the largest direct marketing agency operating exclusively outside London and offers end-to-end integrated direct marketing services both on and off line. In the year to March 2006, it reported revenues of £5.2 million and operating profits of £1.2m. DMG paid £7.8 million for the company in a 50/50 cash/shares deal.

The services offered by the company cover all aspects of online and offline direct marketing including direct mail, direct response press and tv, online banner and viral advertising, and on/offline press relations. It also has a stand-alone service, Dig Research that provides advice on direct marketing strategy. It has a blue chip client base across a range of sectors including finance, retail and leisure. Clients include Tesco, Axa PPP and Toyota. Some 19% of Dig for Fire's gross profit is now derived from online services. The company employs 85 people.

## Cheeze

### *The third cornerstone – a digital media agency*

Cheeze is a digital media planning and buying agency operating entirely in the digital arena. Ranked within the UK's top ten digital media agencies by spend it was voted one of the UK's 50 best companies by Business XL magazine. In January 2006, Cheeze received over 130,000 direct bookings over the web for its clients. Between 2003 and 2005 annual billings increased by 275% to £6.4 million.

Based in Ipswich, Cheeze has additional serviced offices in London and Leeds and employs 25 people. In the year to March 2006 (adjusted) the company generated revenues of £1.5 million and operating profit of £376,000. The business was acquired for £9.5m in a 73/27 cash shares deal.

Cheeze specialises in digital media planning and buying but also offers strategic consultancy, campaign management, search engine marketing (SEM), development and production and Web 2.0 services. SEM accounts for approximately 70% of the company's media billings and it manages over a million clicks every month. It acts for a number of blue chip corporate clients including AXA insurance, Cendant, Budget Car Rental and Monarch Airlines. Historically clients have been concentrated in the travel and insurance sectors giving a seasonal bias towards the first half of the calendar year.

## Jaywing

### *The fourth cornerstone – a data services company*

Jaywing is a leading provider of marketing, credit and fraud consultancy services in the UK specialising in financial services, telecommunications, home shopping and retail. In the year to March 2006 it produced revenues of £8.5million and operating profits of £1.3 million. The cost of acquisition was £14.5million comprising £8.6 million in cash and the remainder in DMG shares.

Its core specialisation is the creation of data systems giving clients sophisticated reporting and modelling capability. This enables clients to improve client marketing, manage credit risk, and reduce fraud. On its consultancy side, the company generally offers in-sourced working whereby Jaywing's staff work as part of the client's team, often at their premises and typically paid on day rates. It also offers out-sourced projects involving the provision of services such as database hosting and campaign management using the client's data on Jaywing's systems. Both these areas generate high gross margins of over 45% and are generally based on long-term contracts. The fastest growing area of business is the provision of data products and services that are expected account for over 50% of revenues by 2009 against 25% now. Jaywing has strong relationships with blue chip corporate clients, including Egg, Powergen, Barclaycard and Sky. It employs 100 people.

## Clients

DMG has an extensive client list covering all industry sectors and including numerous blue chip corporates. Its major clients include Procter and Gamble, Vodafone, Powergen, AXA, AOL, and Tesco.com.

Client contracts and payment vary substantially according to the role the DMG businesses are fulfilling, with income derived from fees, commissions and day rates. The group has established long term relationships with the majority of its clients but, as with all of the industry, generally undertakes work on a project by project basis. These are typically on a three month rollover basis and invoiced monthly.

A digital direct marketing campaign will involve a wide number of different disciplines necessitating multiple agencies working together on any one campaign. DMG now has the services required to provide a client with a one stop service capable of delivering integrated digital direct marketing and giving them greater coordination of their on and off-line programmes. Where more than one DMG company becomes involved in a project, one company will be appointed lead agency and will be responsible for coordinating input from the other group companies. It is expected that clients will be charged a fee for this project management role.

## Integration

Digital marketing has been a key element of each of DMG's business for the past five years and they have all already proved successful at integrating products and services internally or through working with client agencies. In addition, the group companies have already worked with the other businesses on previous projects. However, its directors consider that there is further significant commercial advantage to be gained by offering a broader range of services across the group.

HSM's skill in online and off line direct marketing can undoubtedly be enhanced through the addition of data services, and digital media planning and buying capabilities.

Dig for Fire offers the group the traditional skills of direct marketing in particular strategic planning, direct response advertising and direct mail. It also offers valuable experience in guiding clients through entire direct marketing strategies across all channels.

Cheeze provides digital media planning and buying expertise, strong online experience and a reputation for successful innovation in new digital areas such as Web 2.0.

Jaywing offers invaluable data marketing skills, and a growing expertise in digital data analysis via products like "Digital Brain" and "Signals".

For all four businesses, being part of a larger direct digital marketing group with a broader range of skills, will enable them to compete more effectively across a number of disciplines and improve new business conversion.

In addition, under an integrated digital direct marketing banner, DMG will be able to credibly gain access to the all important new business consultants who control access to some 40-50% of all major new business briefs coming up for pitches.

The integration strategy is based on several key elements:

- Incremental growth derived from marketing the individual businesses as members of a larger digital direct marketing group
- Marketing to existing clients across the entire client base of the group, with a view to cross selling services and also, marketing the new broader range of services to prospective clients.
- Finding synergies and integration benefits across the enlarged group, especially in key support functions and technology. DMG is examining the possibility of developing an integrated marketing platform for both campaign management and delivery and also, a reporting and analysis tool to aid ROI measurement.
- It is also considering full or partial centralisation of administration, finance, personnel and IT management where appropriate.

## Management

The DMG management have considerable experience in both media and investment and proven entrepreneurial skills.

It is seen as a key acquisition criterion by DMG that the CEO/MDs of any new businesses are capable of performing at board level within the Group to facilitate integration and business performance. The CEOs and Managing Directors of the acquired businesses sit on the operations board of the group. This is chaired by Ben Langdon and meets monthly to discuss integration, new business, product quality, client service and financial performance. In addition to Bob Millington, CFO, the operations board includes Gary Stevens from HSM, Charles Buddery from Dig for Fire, Katherine Jerman and Jamie Riddell from Cheeze and Martin Boddy and Andy Gardner from Jaywing.

As in any specialised service industry, the skill and experience of staff is essential and DMG is aware that recruitment and retention are important. It does however have several advantages in that many of the staff have been with the businesses for some years and the

addition of group opportunities and incentives is attractive. Perhaps more importantly, the group's focus on the regions has attracted many highly skilled and experienced personnel who have opted out of the London scene in favour of regional life, and who remain more loyal to their businesses than their London counterparts.

A brief profile of the key board members is given below:

**Stephen Davidson – Non-executive Chairman**

Davidson has been involved in media and telecommunications markets throughout most of his career as FD and then CEO of Telewest and Chairman of the Cable Communications Association. He held several positions in investment banking, most recently as Vice Chairman of Investment Banking at West LB Panmure, which he joined in order to lead their Global Media and Telecoms business. He has substantial experience as Chairman, executive and non-executive director. He is currently chairman of SPG Media and Interaction TV Ltd. He is also a non-executive director of Inmarsat Plc and Datatec Ltd.

**Ben Langdon – Chief Executive**

Langdon has built a successful career in the fields of marketing and advertising. Initially with Dentsu's CDP agency in London then with McCann-Erickson, the world's largest communications group. He has led successful pitches for News International, Bacardi-Martini, Bird's Eye, Glaxo and Esso amongst others. Most recently he has been UK Chairman of Euro RSCG UK, one of the UK's largest marketing services groups, where he oversaw nine companies.

**Robert Millington – Finance Director and Company Secretary**

Millington has served as company secretary and Financial Director of Dig for Fire since 2001 having previously worked in Palamatic Handling Systems and Norton Holdings and run his own accountancy practice.

**Gary Stevens – Executive Director**

Stevens co-founded HSM and has over 16 years experience in direct marketing. He remains CEO of HSM.

## Financials

### Points to note

#### 1/ Presentation of financial information

DMG comprises of companies which have historically had different year ends. HSM and Cheeze have a December year end while Dig for Fire and Jaywing have a March year end. For the purposes of this document and for illustration only, the March 06 comparatives show December 05 figures for HSM and Cheeze. For the year to March 07, our estimates include two businesses with a March year end and two with a December year end. All the businesses will be using a March year end in the future.

#### 2/ Operational leverage

The businesses that make up DMG are essentially “people businesses” so the returns that are generated are, if not proportional to the size of the payroll, then at least influenced by it. In other words, we should not expect every aspect of these businesses to be hugely scalable. That said, we anticipate an improvement in operating margins at the group level over time. This should take place through cost sharing and increased operating efficiency, the ability of DMG to charge more for its services as the benefits of a co-ordinated offering are recognised, Jaywing move towards increased product sales and the benefits gained through DMG business becoming better established and recognised as a brand.

#### 3/ Margins

The operating margins of the four acquired businesses vary slightly according to the nature of the work they carry out:

HSM's Telemarketing business is relatively lower margin as a result of its dependency on the employment of telemarketing personnel, with client revenues directly linked to numbers of people employed.

Conversely its sister business Inbox Digital, and Cheeze, are able to earn higher margins, and higher revenue/EBIT per employee given their sole focus on digital marketing, and digital media planning and buying.

Dig for Fire's recent move into digital marketing (alongside its traditional direct marketing product) and Jaywing's move into digital data products have been part of the strategy by both businesses to bolster margins.

The following table outlines our headline assumptions for the sales and operating profit forecasts.

## Financial forecasts

**Cenkos assumptions and profitability by business pre-central cost**

March YE (£'000)	2005A	2006A	2007E	2008E
<b>HSM</b>				
Existing clients	10	14	16	19
ARPC	287	270	312	331
New clients per annum	4	3	4	4
Net HSM clients	14.0	16.0	19.0	22.0
Average HSM Clients	12.5	15.0	17.5	20.5
Revenue	3,583	4,051	5,466	7,262
Operating Costs	<u>-3,115</u>	<u>-3,402</u>	<u>-4,495</u>	<u>-6,082</u>
EBIT	468	649	971	1,180
Operating Margin	13.1%	16.0%	17.8%	16.3%
<b>Dig For Fire</b>				
Existing clients	14	16	16	17
ARPC	296	321	352	373
New clients per annum	3	1	2	2
Net DFF clients	16	16	17	18
Average DFF Clients	15.0	16.0	16.5	17.5
Revenue	4,435	5,138	5,800	6,368
Operating Costs	-3,505	-3,865	-4,338	-4,737
EBIT	<u>930</u>	<u>1,228</u>	<u>1,417</u>	<u>1,586</u>
Operating Margin	21.0%	23.9%	24.4%	24.9%
<b>Cheeze</b>				
Existing clients	8	8	14	19
ARPC	139	134	143	152
New clients per annum	0	8	6	7
Net Cheeze clients	8	14	19	25
Average Cheeze Clients	8.0	11.0	16.5	22.0
Revenue	1,109	1,471	2,361	3,706
Operating Costs	<u>-800</u>	<u>-1,095</u>	<u>-1,640</u>	<u>-2,579</u>
EBIT	309	376	721	1,127
Operating Margin	27.9%	25.6%	30.5%	30.4%
<b>Jaywing</b>				
Existing clients	12	12	65	69
ARPC	432	149	155	164
New clients per annum	1	54	5	5
Net Jaywing clients	12	65	69	73
Average Jaywing Clients	12.0	57.0	67.0	71.0
Revenue	5,189	8,482	10,372	13,470
Operating Costs	-4,641	-7,100	-8,034	-10,495
EBIT	<u>548</u>	<u>1,332</u>	<u>2,288</u>	<u>2,925</u>
Operating Margin	10.6%	15.7%	22.1%	21.7%
<b>Group revenue</b>	<u>14,316</u>	<u>19,142</u>	<u>23,999</u>	<u>30,806</u>

Source: Cenkos Securities \*NOTE leaving clients, and amortisation are not shown in the above calculations

The above assumptions feed through into the following financial forecasts

#### P&L forecasts

March YE (£'000)	2005A	2006A	2007E	2008E
Revenues	14,316	19,142	23,999	30,806
General and Administrative Expenses	-12,061	-15,462	-19,299	-24,892
Amortisation	0	-95	-95	-95
Total Operating costs	-12,061	-15,557	-19,394	-24,987
EBITA	2,255	3,680	4,700	5,914
Operating profit	2,255	3,585	4,605	5,819
Interest costs	0	0	-746	-750
Profit before tax	2,255	3,585	3,859	5,069
Tax actual	0	0	-1,158	-1,521
Tax normalised	-677	-1,076	-1,158	-1,521
Profit after Tax	2,255	3,585	2,701	3,548
Profit After Tax at Normalised Rate Pre Amortisation & Exceptionals	1,579	2,605	2,796	3,643
EPS	-	-	5.4	7.1

Source: Cenkos Securities

### Summary

We believe that DMG has a strong competitive advantage in the fast growing digital direct marketing space through its unique, comprehensive offering, the quality of its underlying businesses and management's exceptional track record in delivering growth.

We anticipate a strong increase in earnings supported by top line growth, a low cost structure and implementation of operational efficiencies. We believe that DMG will be re-rated to 15x FY08 within the medium term as evidence that Management are delivering continues. This suggests a share price target of 109p, a 43% upside on the current price.

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