

THE BITCOIN BREAKDOWN & 2014 OUTLOOK

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WHAT IS BITCOIN?

In just a few short years, Bitcoin has become a global phenomenon. Its appeal varies across user groups with consumers appreciating its decentralized and deflationary qualities and retailers valuing its low cost of acceptance.

"Bitcoin" can be separated into two categories: the Bitcoin "coin" (denoted by a capital "B") and the bitcoin "network" (denoted by a lowercase "b"). The Bitcoin "coin" is not an actual coin but rather a private "key" that gives the holder ownership rights to a specified value maintained on a digital ledger known as the blockchain. The bitcoin network is a global decentralized system running the bitcoin protocol that maintains the blockchain and processes transactions.



While governments were initially worried about the potential for money laundering via Bitcoin, many (including the United States) are beginning to understand the innovation behind the bitcoin network and are looking to regulate the use of Bitcoin rather than shut it down. We believe other countries will follow suit when they become more informed of the potential for Bitcoin to benefit retailers and consumers.

DEMAND FOR BITCOIN

In the near term, we see three key sources of demand for Bitcoin:

Disruptive Payment Network Technology

By decentralizing processing and thus allowing for market-based fees and new functionality, bitcoin technology provides a powerful alternative to branded technology such as Western Union and Visa/MasterCard. The initial benefits of bitcoin technology may be in the processing of micro transactions, due to its flexible fee structure and competitive price/lag dynamics, and cross-border payments which would benefit from the ability to avoid currency translation or conducting the foreign exchange outside the payment network.

Alternative Uncorrelated Asset Class

Given the intrinsic value of the payment network we see the potential for Bitcoin to be used as an uncorrelated asset class potentially replacing some demand for gold and other financial assets.

Safe Haven Currency

As a currency of refuge, we believe Bitcoin represents a way for consumers in high-inflation countries to preserve the value of their income.

As the network matures and new functionality is added, we believe the bitcoin network will be used to transfer other asset classes beyond the currency. With the latest evolution of the bitcoin protocol to allow embedded metadata and code in the blockchain we believe bitcoin's potential lies beyond the "coin" as the underlying blockchain protocol can be used to replace traditional intermediaries by acting as an exchange mechanism for a multitude of transactions. In the same way as bitcoin can eliminate centralized trust in payments, we believe the same digitized and decentralized trust mechanism can impact transactions that currently involve a central intermediary including securities markets, sports gambling, and even legal contracts.

BITCOIN OUTLOOK

We believe 2014 will be the year of bitcoin innovation with increased consumer adoption occurring in future years. We expect recent investments in bitcoin startups by venture capital firms Andreessen Horowitz (Coinbase), Founders Fund (Bitpay), and Accel (Circle) to lead to additional VC investments as the value of the bitcoin technology becomes more broadly known and appreciated. We believe many of these new ventures will be formed with the goal of making bitcoin accessible to the mainstream in the way browsers/HTML/HTTP did for the Internet.

We view the rapid growth of Coinbase (over 1 million user accounts, more than double since October 2013) and Bitpay (\$100 million in processed Bitcoin transactions) as an indication that consumers are receptive to Bitcoin as a financial asset and medium of exchange. We expect this trend to continue as the bitcoin protocol exits beta and Bitcoin becomes more accessible to the mainstream public. We believe new users will either enter the bitcoin network

knowingly through an exchange or unknowingly through companies such as ZipZap that leverage the bitcoin network to facilitate remittances. We also expect current price volatility to stabilize and see the recent resilience in the wake of Bitcoin exchange Mt. Gox failing as an encouraging sign. In the meantime, merchant acquirers such as Bitpay, Coinbase, GoCoin, and Circle will offer to shield merchants from current volatility.

We also expect bitcoin regulations to be codified, adding legitimacy and structure to the ecosystem. Due to unclear and evolving regulation around the status of crypto currencies, bitcoin businesses are finding it increasingly difficult to secure banking relationships. Clarified regulations should help remove the stigma (from a banking perspective) around bitcoin businesses contributing to an acceleration of bitcoin innovation.

BITCOIN'S BEST CASE UPSIDE

Based on the order of magnitude of the overall opportunity and some (admittedly) rough calculations we believe scenarios exist by which Bitcoin could be worth 10-100x its current price (Figure 1). We believe rising Bitcoin prices help build the network thus entrenching its value vis-a-vis other payment networks. We view the recent price volatility in Bitcoin prices a result of extended price discovery as the market overcomes substantial friction and the very divergent set of outcomes. Based on our framework, we believe the market is pricing in less than 1% penetration over the next 10 years. Conversely, if a better crypto-currency emerges that does not rely on Bitcoin's infrastructure, Bitcoin may be worth far less than its current market value.

Wedbush Securities is the first financial institution to accept Bitcoin payments for its award-winning research platform. For more information, please visit www.wedbush.com/bitcoin.

	Years to Achieving Peak Penetration			
	20	10	5	1
1%	\$520	\$1,041	\$2,081	\$10,407
5%	2,602	5,204	10,407	52,035
10%	5,204	10,407	20,814	104,070
20%	10,407	20,814	41,628	208,141

(in millions)

Global Foreign Currency Reserves	\$7,453,736 ⁽¹⁾
Money Supply in High Inflation Countries	\$4,305,488 ^{Figure}
Gold as Financial Asset	\$1,900,000 ⁽²⁾
Total Potential Aggregate Demand	\$13,659,224

Estimated supply in 2014 13 million BTC

(1) Source: IMF
(2) Source: WGC

AUTHORS



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