

# OTC Markets Group

Q217 results

Positive revenue and profit trends

OTC Markets Group's (OTCM) Q2 results were ahead of our expectations, with a 3% revenue beat translating into operating profits nearly 10% above our estimate: evidence of the potential operational gearing present in the business. We have increased our pre-tax profit estimates by 6% and 8% for this year and next while, on a longer view, the continued increase in the number of states that grant OTCM markets Blue Sky recognition should increase the appeal of these cost-effective trading venues to corporates.

Year end	Revenue (\$m)	PBT* (\$m)	EPS* (\$)	DPS** (\$)	P/E (x)	Yield (%)
12/15	49.9	16.9	0.88	1.08	28.1	4.4
12/16	50.9	16.9	0.99	1.16	25.0	4.7
12/17e	54.8	18.7	1.03	1.20	24.0	4.8
12/18e	57.2	19.5	1.06	1.22	23.3	4.9

Note: \*Fully diluted and calculated after restricted stock awards and excluding exceptional items and amortisation of acquired intangibles. \*\*Including special declared dividends of \$0.60 for 2015 and 2016, and an estimated \$0.64 and \$0.66 for 2017 and 2018 respectively.

## Q217 shows good progress

Second quarter revenue was 9% ahead of Q216, primarily driven by strength in Corporate Services where price increases applied in the OTCQX market were supported by an increase in the number of OTCQB companies and revenue from disclosure, news and other services. Market Data Licensing also contributed increased revenues, but OTC Link ATS saw a 6% reduction as the contraction in the number of broker-dealer participants continued, reflecting pressures on their businesses. Contained operating costs allowed pre-tax profits to increase by 17.5%. Operating cash flow before working capital was up 19% compared with Q216. While the incidence of working capital fluctuations gave rise to an outflow, the cash balance remains above \$20m. An unchanged quarterly dividend of \$0.14 has been declared.

## Near-term uncertainties but longer-term promise

Geopolitical and macroeconomic uncertainties persist, but otherwise the background seems generally promising for OTCM; IPO activity has picked in the first half suggesting greater confidence among corporates and market participants, while the US economy has shown continued resilience. Longer term, OTCM's cost-effective offering of tiered markets designed to be less onerous for companies but transparent for investors appears well suited to the further development of online fund-raising, which is likely to create a larger pool of clients for such a service.

## Valuation: Increased on raised estimates

OTCM trades on prospective P/E multiples broadly similar to information provider and global exchange comparators (page 7). However with long-term potential to gain significantly greater traction with corporates and scope to deliver operational gearing further positive earnings surprises are possible. Reflecting current earnings upgrades we see a fair value of c \$26 as reasonable (\$22 previously).

### Financial services

15 August 2017

**Price** **US\$24.75**  
**Market cap** **US\$282m**

Net cash (\$m) at end June 2017	22.6
Shares in issue	11.4m
Free float	60%
Code	OTCM
Primary exchange	OTCQX
Secondary exchange	N/A

### Share price performance



%	1m	3m	12m
Abs	0.8	12.5	46.4
Rel (local)	0.5	9.1	29.7
52-week high/low	US\$26.0	US\$16.7	

### Business description

OTC Markets Group operates the OTCQX, OTCQB and Pink financial markets for c 10,000 US and global securities. Its trading system, OTC Link ATS, is operated by OTC Link LLC, a member of FINRA, and is an SEC-regulated Alternative Trading System.

### Next events

Q317 results	November 2017
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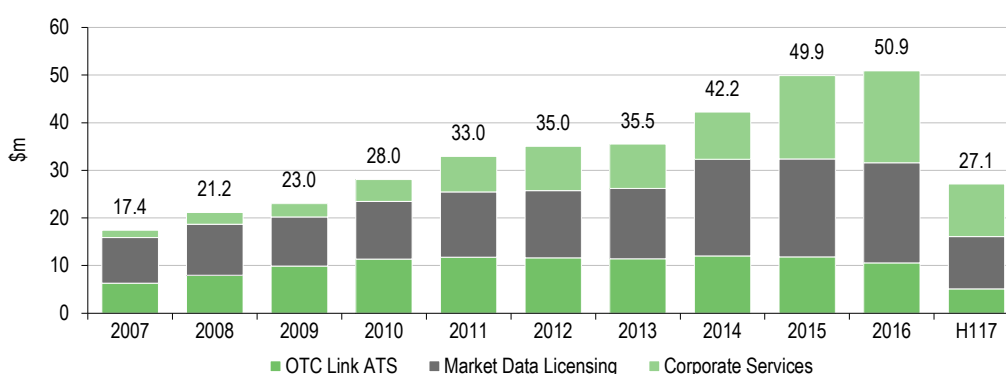
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## Company description: Less painful markets

OTCM's strategy is to build business-friendly markets for global and US companies with an emphasis on ensuring that information on corporates is widely available through open networks to help investors make informed choices. The tiered markets it operates further this objective by applying graduated criteria, which suit a range of companies capable of meeting different standards of disclosure while providing a venue for broker-dealer subscribers to facilitate trade across a spectrum of issuers. The combination of a digital platform that provides necessary information to broker-dealers and investors but is less onerous for corporates with attractive pricing makes for what CEO, Cromwell Coulson, terms "less painful" markets when compared with national securities exchanges such as Nasdaq and NYSE.

We estimate that over 80% of OTCM's revenue can be described as subscription in nature rather than transactional. This includes broker-dealer subscriptions, market data licences and initial and annual charges for companies on the premium OTCQX and OTCQB markets. In Q217 OTC Link ATS (trading services) accounted for 18% of revenues, Market Data 40% and Corporate Services (mainly charges to companies on OTCQX and OTCQB markets) 42%. The development of revenue is shown in Exhibit 1. In addition to the healthy overall compound annual growth rate of 13% between 2007 and 2016, the other salient feature is the expansion of Corporate Services within the total (CAGR 32%), reflecting the development of the premium markets. In the first half of the current year revenue was 7% ahead of H116. We discuss Q217 results in the next section.

**Exhibit 1: Longer-term gross revenue analysis**



Source: OTCM, Edison Investment Research

## Q217 results

OTCM reported second quarter net revenue growth of 9%, compared with the same period last year. This fed through to an increase in income from operations of 17% as operating expense growth was contained at below 5% with reduced marketing spend and professional fees mitigating increases in compensation, IT and occupancy costs. Compared with Q117 revenue was up by 3%, while a small reduction in operating expenses allowed income from operations to increase by 14% sequentially. Operating margin in Q217 increased to 37% compared with 34% in Q216. A dividend of \$0.14 was declared, the ninth at this level and the 35th consecutive quarterly payment.

As shown in Exhibit 2, there was a marked difference in revenue growth in the three business areas. **OTC Link ATS** saw a 6% decline versus Q216 reflecting a combination of the continued contraction and consolidation in the number of participating broker-dealers, together with a greater concentration of activity in a small number of stocks, which meant that the growth in dealing

volumes did not result in a similar increase in quote-related fees (these are charged on a flat daily per stock basis). **Market Data Licensing** recorded a 5% increase in revenue with a modest reduction in the number of professional users more than offset by a 36% increase in non-professional users, together with increased sales of and pricing for compliance data file and analytics products, which are used by clients to help automate risk monitoring processes. Finally, there was a substantial, 21%, increase in **Corporate Services** revenue, which was mainly the result of increased prices for the OTCQX market and an increase in the number of OTCQB corporate clients versus Q216. Revenue in this segment is split approximately 35/45/20 between OTCQX, OTCQB and disclosure, news and other services, which also contributed to the increase in revenues.

**Exhibit 2: Q217 results summary**

(\$000s unless stated)	Q216	Q117	Q217	% change vs Q216	% change vs Q117
OTC Link ATS	2,658	2,618	2,497	(6.1)	(4.6)
Market data licensing	5,237	5,450	5,522	5.4	1.3
Corporate services	4,744	5,308	5,750	21.2	8.3
<b>Gross revenues</b>	<b>12,639</b>	<b>13,376</b>	<b>13,769</b>	<b>8.9</b>	<b>2.9</b>
Re-distribution fees and rebates	(584)	(624)	(626)	7.2	0.3
<b>Net revenue</b>	<b>12,055</b>	<b>12,752</b>	<b>13,143</b>	<b>9.0</b>	<b>3.1</b>
Operating expenses	(7,936)	(8,514)	(8,319)	4.8	(2.3)
Income from operations	4,119	4,238	4,824	17.1	13.8
Other income / net interest	4	14	22	450.0	57.1
<b>Income before provision for income taxes</b>	<b>4,123</b>	<b>4,252</b>	<b>4,846</b>	<b>17.5</b>	<b>14.0</b>
Taxes	(1,608)	(1,202)	(1,741)	8.3	44.8
<b>Net income</b>	<b>2,515</b>	<b>3,050</b>	<b>3,105</b>	<b>23.5</b>	<b>1.8</b>
<b>Diluted EPS \$</b>	<b>0.21</b>	<b>0.26</b>	<b>0.26</b>	<b>22.6</b>	<b>1.9</b>
Operating margin	34%	33%	37%		

Source: OTCM, Edison Investment Research

The next table summarises key operating data for each segment confirming some of the trends mentioned above. Within OTC Link ATS there was a 13% decline in the number of active participants from Q216 and OTCM cites declining volumes in equity markets, margin pressure on broker trading revenue arising from automation and rising regulatory costs as putting pressure on the number of participants. The concentration of trading in a smaller number of stocks is evident in a marked reduction in revenues expressed in bp of volume traded.

**Exhibit 3: Operating and related revenue data**

	Q216	Q117	Q217	% change vs Q216	% change vs Q117
<b>OTC Link ATS</b>					
Number of securities quoted	9,738	9,638	9,562	(1.8)	(0.8)
Number of active participants	112	99	97	(13.4)	(2.0)
Revenue per security quoted (\$)	273	272	261	(4.3)	(3.9)
Revenue per average active participant (\$)	23,316	25,541	25,480	9.3	(0.2)
Revenue bp of volume traded	0.60	0.47	0.45	(25.6)	(4.0)
<b>Corporate Services</b>					
Number of corporate clients					
OTCQX	383	363	355	(7.3)	(2.2)
OTCQB	877	928	912	4.0	(1.7)
Pink	674	676	722	7.1	6.8
Total	1,934	1,967	1,989	2.8	1.1
Revenue per client (\$)	2,453	2,699	2,891	17.9	7.1
<b>Market Data Licensing</b>					
Market data professional users	20,904	20,700	20,625	(1.3)	(0.4)
Market data non-professional users	10,832	16,022	16,204	49.6	1.1
Revenue per terminal (total)	165	148	150	(9.1)	1.0

Source: OTCM, Edison Investment Research

For Corporate Services, client numbers at end June were down year-on-year for OTCQX, but up for OTCQB. The decline in OTCQX reflects a relatively muted level of new additions during 2016 (60

versus 126 in 2015) together with the removal of 26 companies that did not meet new eligibility criteria at the 2017 annual renewal stage. Positively, the level of new sales in the first two quarters was up from 24 last year to 40 this year.

There has been a step-up (+50%) in the number of non-professional market data users, which is attributed to a broad increase in the participation of retail investors in equity markets and OTCM's initiatives to extend its distribution network including new relationships with Just2Trade and Tiger Trade Technologies during 2016.

OTCM has continued to work towards increasing the number of states which accept the disclosure provided by OTCQX and OTCQB for the purpose of Blue Sky recognitions that generally allow investment professionals to recommend qualifying securities to investors or purchase them for managed portfolios. In Q217 a further four states were added to the list, taking the total recognising OTCQX to 25 and OTCQB to 22 (see Exhibit 4). This marks the halfway point in reaching national recognition, potentially making the task of adding further states easier and enhancing the reputation of the two premium markets.

**Exhibit 4: Blue Sky recognition for OTCQX and OTCQB**

State	Recognition	State	Recognition
Alaska	Both	New Mexico	Both
Arkansas	Both	Ohio	Both
Colorado	Both	Oregon	Both
Delaware	Both	Rhode Island	Both
Georgia	Both	South Dakota	Both
Idaho	OTCQX only	Texas	Both
<b>Indiana</b>	<b>Both</b>	<b>Utah</b>	<b>Both</b>
Iowa	Both	Vermont	OTCQX only
Kansas	OTCQX only	Washington	Both
<b>Maine</b>	<b>Both</b>	<b>West Virginia</b>	<b>Both</b>
Mississippi	Both	Wisconsin	Both
Nebraska	Both	Wyoming	Both
New Jersey	Both		

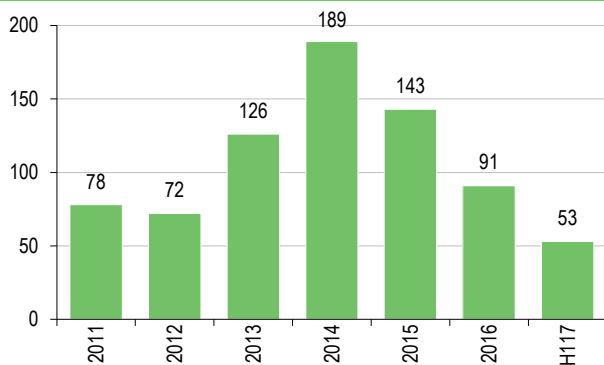
Source: OTCM. Note: New states added since Q117 announcement in bold.

In May OTCM acquired **theOTC.today**, a website that monitors and analyses potentially manipulative stock promotion campaigns. While, based on 2016 promotion data from theOTC.today, the amount of trading in promoted securities was only 2.04% of the total dollar volume on the OTC market, this acquisition provides OTCM with access to a valuable historical database and furthers the company's strategy of increasing the availability of information so that investors can make informed decisions.

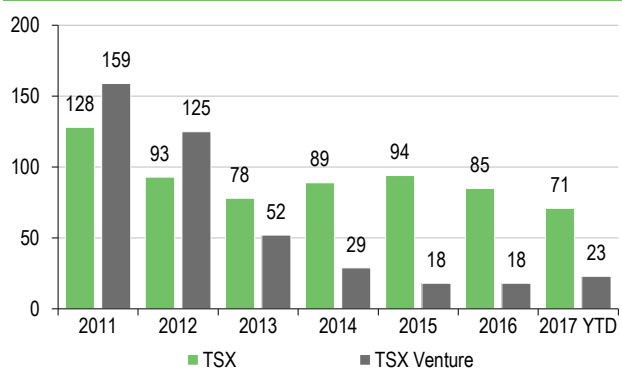
The **Transfer Agent Verified Shares Program**, another initiative to increase transparency by assembling data on share issuance, has added further participants taking the total of transfer agents to 12 (previously 10).

## Current trading environment and outlook

Equity capital markets in North America and the UK that are potentially relevant to OTCM have generally shown some improvement in trends in the first half of 2017. Starting with Nasdaq (Exhibit 5), the number of IPOs has been on a downtrend since 2014 but strengthened noticeably in the second quarter, allowing the first half run rate to move ahead of both the first half and full year total for 2016. There has also been an improvement in the run rate for both the Canadian TMX markets' year to date (end-July) annualised run rate of IPOs (Exhibit 6).

**Exhibit 5: Nasdaq – number of IPOs**


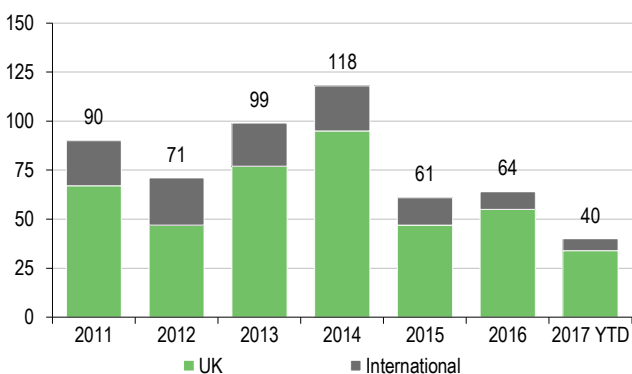
Source: Nasdaq

**Exhibit 6: TSX and TSX Venture – number of IPOs**


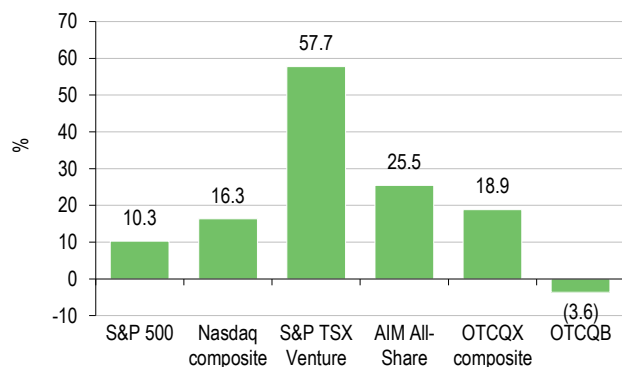
Source: TMX. Note: 2017 ytd to end July.

After a soft start to the year, the level of IPOs on the UK AIM (Exhibit 7) has picked up and is now running ahead of the 2016 level both in terms of number of companies and money raised, despite uncertainty arising following the general election result and surrounding Brexit.

In the US the 'Trump bump' appears to have fully dissipated and geopolitical uncertainties could act to reduce confidence and the pace of IPOs but, with the economy displaying continued resilience, the background is potentially better than it appears at first sight. In the markets mentioned here there has also been a positive performance in most cases, markedly so for the TSX Venture exchange but also for AIM and the OTCQX index, which both outpaced the Nasdaq index over the six-month period shown (see Exhibit 8). Providing political and economic developments do not intervene there may be scope for a more positive full year for new issues, an environment that could also be helpful for OTCM in signing up new clients.

**Exhibit 7: AIM number of admissions**


Source: AIM. Note: Ytd to end July.

**Exhibit 8: Six-month index performance (US\$ terms)**


Source: Bloomberg. Note: Total return, to 12 August 2017.

As noted earlier, the trend in new client additions for OTCM has improved in the last two quarters and the annual retention rate at OTCQX was higher at 93% for 2017 compared with 89% in 2016. Further, the level of churn (for the year to date) at OTCQB has dropped from 21% to 17% compared with the same period last year.

The continued growth in number of Blue Sky recognitions is encouraging and may be reaching a tipping point at which the recognition of the premium markets rises significantly, enabling OTCM to attract increasing numbers of corporate clients with its cost-effective offering.

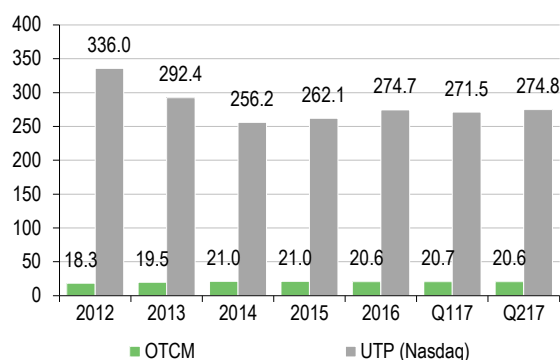
So far the loss of Global OTC ATS as subscriber and its launch as a direct competitor for OTCM Link ATS in May this year has not had a material impact on revenues and the reported [market share](#) of Global OTC ATS does not appear to have changed noticeably. However, OTCM monitors

the situation closely and is focusing on enhancing its services to broker-dealers to address the challenge.

On a longer view OTCM remains optimistic that the potential impact of the development of online or crowd-funded capital-raising facilitated by the Jumpstart Our Business Startups (JOBS) Act (including Regulation A+ and Regulation Crowdfunding) will be positive for its own business. Companies exploiting the opportunities provided by these developments (possibly including SEC reporting companies in due course) may be more likely to be attracted to the relatively low-cost markets operated by OTCM.

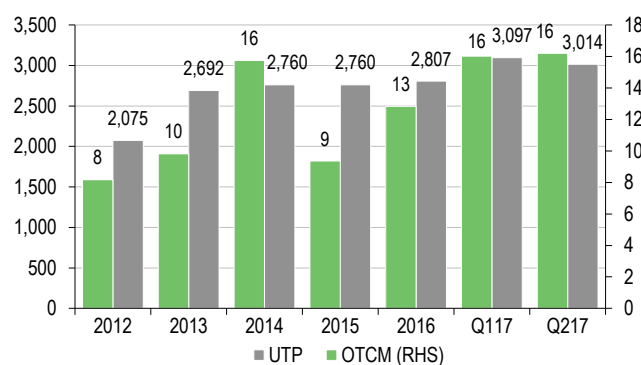
Turning to market data licensing, Exhibits 9 and 10 show the trends in professional and non-professional users of OTCM and Nasdaq data. The first point to note is the relatively small size of the professional OTCM data user base compared with Nasdaq (stable at 7.5% Q217), suggesting significant upside as its markets gain greater traction. If delivered, this would act to counter the downtrend in the number of participating broker-dealers noted in our discussion of OTC Link ATS.

**Exhibit 9: OTCM and UTP (Nasdaq) professional users**



Source: OTCM, UTP Plan, Edison Investment Research

**Exhibit 10: OTCM and UTP non-professional users**



Source: OTCM, UTP Plan, Edison Investment Research

Drawing these points together, we see risks to the overall equity market background, but the continued resilience of the US economy and stock market levels give encouragement that the pace of corporate activity could be sustained, creating a favourable background for OTCM client additions. Blue Sky recognitions do not directly lead to revenue benefits for OTCM but on a longer view should be helpful, particularly if further recognitions continue to flow through. Legislative and regulatory changes designed to facilitate companies raising equity capital also have the potential to enlarge the pool of potential clients for OTCM. OTC Link ATS faces the challenge of shrinkage in the number of broker-dealer participants (also affecting Market Data Licensing) plus competition from Global OTC ATS and others. However, OTCM's focus on improving the service to broker-dealers is a positive response and the early signs on competitive impact are encouraging. In the next section we discuss our forecast changes and the group's financial position.

## Financials

We have increased our overall revenue assumptions for FY17 and FY18 by 2% (see Exhibit 11), but within this have trimmed our expectation for OTC Link ATS reflecting the Q2 result, and increased our estimate for Corporate Services and (modestly) Market Data Licensing. Reflecting operational gearing, this feeds through to an increase in pre-tax profit estimates of 6% and 8% for FY17 and FY18 respectively with similar increases in EPS. For the moment, our estimates for dividends are unchanged and we assume special dividends for both years (\$0.64 and \$0.66) such that the overall dividend continues to grow.

**Exhibit 11: Earnings revisions**

	Gross revenue (\$m)			PBT (\$m)			EPS (\$)			Dividend (\$)		
	Old	New	Change	Old	New	Change	Old	New	Change	Old	New	Change
2017e	53.8	54.8	2%	17.6	18.7	6%	0.96	1.03	7%	1.20	1.20	0%
2018e	55.9	57.2	2%	18.1	19.5	8%	0.97	1.06	8%	1.22	1.22	0%

Source: Edison Investment Research

Operating cash flow before working capital movements in Q217 was nearly 19% above the same period last year, although the incidence of quarterly working capital swings generated a somewhat larger seasonal cash outflow in the period. Nevertheless, the cash position (no debt) remains strong at \$22.6m compared with \$25.0m at the year end and \$23.3m at the same point last year. Over the 12 months to end June OTCM paid dividends of \$13.1m and bought back shares into treasury to the value of \$2.6m.

## Valuation

We have updated the comparative P/E table used in previous notes (Exhibit 12). This includes global exchanges and information providers MSCI and Markit, which can be seen as having some parallel with OTCM's subscription-based fees and market data income. OTCM trades on multiples just below and just above the consensus averages for the exchanges and information providers for FY17 and FY18 respectively. The potential for operational gearing on any further increases in revenue estimates resulting from greater corporate activity in the near term or increased traction of the OTCM's premium markets on a longer-term view could trim multiples or warrant a higher valuation on a discounted cash flow basis (see below).

**Exhibit 12: OTCM comparative multiples**

	Estimated P/E ratios (x)	
	FY17e	FY18e
MSCI	29.0	24.7
Markit	22.3	19.4
<b>Average information providers</b>	<b>25.7</b>	<b>22.0</b>
<b>Average global exchanges</b>	<b>24.6</b>	<b>21.1</b>
S&P 500	18.9	17.0
<b>OTCM</b>	<b>23.8</b>	<b>23.2</b>

Source: Bloomberg, Edison Investment Research. Note: Prices as at 14 August 2017.

Factoring our increased estimates into our discounted cash flow model and adjusting assumptions to match the current share price (\$24.75 on 14 August 2017), one combination that fits would be a discount rate of 10.2%, a long-term growth rate of 4% and a terminal multiple of 16x (compares with a current year value of c 18x). A sensitivity table below shows how the DCF valuation changes with discount rate and growth assumptions. Taking the comparative P/E multiples into account, we see a fair value of c \$26 as reasonable (previously \$22).

**Exhibit 13: Discounted cash flow valuation sensitivity (\$ per share)**

Discount rate (right)	7%	8%	9%	10%	11%
2019-27e growth					
2%	28.1	26.3	24.6	23.1	21.7
3%	29.8	27.8	<b>26.0</b>	24.4	22.9
4%	31.7	29.6	27.6	25.8	24.2
5%	33.7	31.4	29.3	27.4	25.6

Source: Edison Investment Research



**Exhibit 14: Financial summary**

\$000s	(US GAAP)	2015	2016	2017e	2018e
Year end 31 December					
<b>PROFIT &amp; LOSS</b>					
OTC Link ATS		11,796	10,573	9,975	9,676
Market Data Licensing		20,610	21,054	22,072	22,955
Corporate Services		17,503	19,254	22,758	24,579
Revenue		49,909	50,881	54,805	57,209
Re-distribution fees and rebates		(2,379)	(2,317)	(2,510)	(2,575)
Net revenue		47,530	48,564	52,295	54,634
Operating expenses		(28,972)	(30,032)	(32,039)	(33,481)
EBITDA		18,558	18,532	20,256	21,154
Depreciation		(1,692)	(1,606)	(1,594)	(1,650)
Operating profit		16,866	16,926	18,662	19,504
Net interest		27	9	46	20
Profit Before Tax		16,893	16,935	18,708	19,524
Tax		(6,635)	(6,407)	(6,403)	(6,833)
Profit after tax (FRS 3)		10,258	10,528	12,305	12,690
Profit after tax (norm)		9,971	11,260	11,993	12,378
Fully diluted av. No. of shares (m)		11.3	11.3	11.6	11.7
EPS - normalised (c)		88.3	99.3	103.0	105.8
Fully diluted EPS - FRS 3 (c)		90.6	101.5	105.3	108.1
Dividend per share (c)		108.0	116.0	120.0	122.0
EBITDA Margin (%)		39	38	39	39
Operating profit margin (%)		35	35	36	36
<b>BALANCE SHEET</b>					
Non-current assets					
Intangible assets		291	291	437	537
Property and other		4,187	3,267	2,671	1,661
Current assets					
Debtors		6,082	6,262	5,196	5,196
Cash & cash investments		23,925	25,034	24,477	26,615
Other current assets		1,729	1,789	3,039	3,039
Current liabilities					
Deferred revenues		(12,737)	(14,664)	(15,200)	(16,000)
Other current liabilities		(5,063)	(5,372)	(5,420)	(5,420)
Long-term liabilities					
Tax, rent and other		(867)	(1,101)	(1,327)	(1,327)
Net assets		17,547	15,506	13,873	14,301
NAV per share (\$)		1.55	1.36	1.22	1.24
<b>CASH FLOW</b>					
Operating cash flow		22,400	21,752	22,581	23,605
Net Interest		27	9	46	20
Tax		(5,320)	(6,021)	(6,700)	(6,833)
Capex / intangible investment		(940)	(415)	(756)	(740)
Financing / investments		(420)	(1,157)	(2,025)	0
Dividends		(12,094)	(13,059)	(13,703)	(13,914)
Net cash flow		3,653	1,109	(557)	2,137
Opening net (debt)/cash		20,272	23,925	25,034	24,477
Closing net (debt)/cash		23,925	25,034	24,477	26,615

Source: OTC Markets Group accounts, Edison Investment Research



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