

OTC Markets Group

Q317 results

Growing revenues and investing for the future

OTC Markets Group's (OTCM) third quarter results showed further progress with pre-tax profits up by 4% versus Q316 despite a 10% increase in operating expenses to support IT systems and new services. OTCQX and OTCQB received Blue Sky recognition from a further two states taking the total to 27 for OTCQX. Strategic alliances have been established that should help extend OTCM's geographical reach and broaden the services offered to corporate clients.

Year end	Revenue (\$m)	PBT* (\$m)	EPS* (\$)	DPS** (\$)	P/E (x)	Yield (%)
12/15	49.9	16.9	0.88	1.08	27.7	4.4
12/16	50.9	16.9	1.06	1.16	23.2	4.7
12/17e	54.4	18.3	1.06	1.16	23.1	4.7
12/18e	57.6	19.8	1.07	1.19	22.8	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.

Q317 results

Third quarter revenue increased by 8% compared with the same period last year. The main driver of growth was the Corporate Services segment (+19%), benefiting from increased client numbers at OTCQB and a fee increase at OTCQX. Revenues fell at OTC Link ATS as a further reduction in participants coupled with lower quote volumes generally limited fee income. Expenses increased, as noted, trimming the operating margin by one percentage point to 35% and pre-tax profit increased by 4% to \$4.6m. One-off tax claims relating to prior years reduced the tax rate to 24%, so earnings per share increased by 14.5% to \$0.29. OTCM announced a fourth quarter dividend of \$0.14 and a special dividend \$0.60 (equalling last year).

Strategic focus

OTCM maintains its focus on providing "less painful" market access to corporates, an attractive offering to broker dealers and transparency to investors; a number of announcements with the Q3 figures reflect this. A strategic alliance with the Canadian Stock Exchange will facilitate access to North American markets by international companies, while another with Issuer Direct will allow corporates convenient access to communication and compliance services. In a move to provide an additional trading option for broker-dealer subscribers OTCM is to launch an Electronic Communications Network before the end of the year. Externally, it is difficult to predict the pace of development of online fund-raising, but it could generate a large pool of potential clients fuelling long-term revenue growth.

Valuation

OTCM shares trade on earnings multiples that are in the range of those ascribed to global exchanges and information providers. The opportunity for OTCM to increase scale as its markets gain traction could provide significant earnings and valuation upside. With only minor earnings estimate changes (see page 6), we maintain our fair value at c \$26.

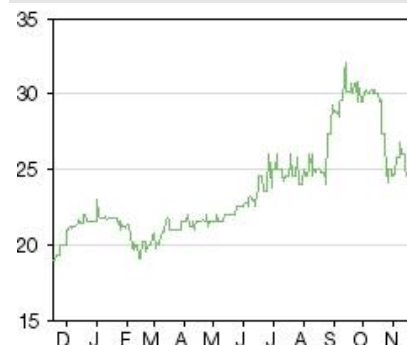
Financial services

16 November 2017

Price US\$24.5
Market cap US\$280m

Net cash (\$m) at end Sept 2017	24.6
Shares in issue	11.4m
Free float	60%
Code	OTCM
Primary exchange	OTCQX
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	(17.2)	(0.6)	30.8
Rel (local)	(17.5)	(4.5)	11.2
52-week high/low	US\$32.0	US\$19.0	

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. We estimate c 80% of revenues are on a subscription basis.

Next events

FY17 results	March 2018
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Q317 results: Growth and investment for the future

OTCM reported third quarter revenue growth of 8% compared with Q316, while operating expenses increased by 10%, in part reflecting increased investment in personnel and technology to support existing and new services for customers. This left the operating profit margin down one percentage point and profit before tax up 4% compared with the prior year period.

Key points from the results are highlighted below (comparisons with Q316 unless stated) with a summary of quarterly figures given in Exhibit 1.

- Within the overall **revenue** increase the main driver of growth was Corporate Services (+19%) where the largest contributor (+21%) was OTCQB (46% of segment revenues) in part reflecting a 6% increase in the number of clients. OTCQX revenues also increased strongly (+18%) despite a reduction in the number of companies (-8%) that was more than offset by a price rise (from \$15,000 to \$20,000) that came into effect for new clients in 2016 and existing clients at the beginning of 2017.
- Operating **expenses** increased by 10%. Compensation accounted for 62% of the total and IT infrastructure and information services 18%. Consulting fees only account for 7% of expenses but bumped up in the quarter as one-time costs associated with tax and regulatory advice were incurred.
- **Pre-tax profit** increased by 4% to \$4.6m, 5% below the second quarter figure.
- **The tax rate** fell sharply from 32% to 24% mainly as a result of the one-off benefit of claims relating to prior years for a federal Domestic Production Activities Deduction and a lower rate available in New York state for a Qualifying Emerging Technology Company. There will be a continuing modest benefit from these savings prospectively.
- The lower tax rate meant that **earnings per share** increased by 14.5%.
- OTCM announced a fourth quarter **dividend** of \$0.14 (tenth payment at this level) and a \$0.60 special dividend (equalling the special dividend paid last year).

Exhibit 1: Q317 results summary						
(\$000s unless stated)	Q316	Q117	Q217	Q317	% change vs Q316	% change vs Q217
OTC Link ATS	2,530	2,618	2,497	2,413	(4.6)	(3.4)
Market Data Licensing	5,274	5,450	5,522	5,505	4.4	(0.3)
Corporate Services	4,809	5,308	5,750	5,704	18.6	(0.8)
Gross revenues	12,613	13,376	13,769	13,622	8.0	(1.1)
Re-distribution fees and rebates	(557)	(624)	(626)	(584)	4.8	(6.7)
Net revenue	12,056	12,752	13,143	13,038	8.1	(0.8)
Operating expenses	(7,658)	(8,514)	(8,319)	(8,448)	10.3	1.6
Income from operations	4,398	4,238	4,824	4,590	4.4	(4.9)
Other income/net interest	11	14	22	5	(54.5)	(77.3)
Income before provision for income taxes	4,409	4,252	4,846	4,595	4.2	(5.2)
Taxes	(1,404)	(1,202)	(1,741)	(1,107)	(21.2)	(36.4)
Net income	3,005	3,050	3,105	3,488	16.1	12.3
Diluted EPS (\$)	0.26	0.26	0.26	0.29	14.5	11.6
Operating margin	36%	33%	37%	35%		

Source: OTCM, Edison Investment Research

Our next table (Exhibit 2) shows operating data for the three business segments. For OTC Link ATS the overall number of securities quoted was modestly higher but, more importantly, the number of broker-dealer participants has continued to contract either through withdrawal from the market or consolidation. This reflects an environment of lower volumes, margin contraction arising from increased automation and rising regulatory costs. Further, while the dollar value of trading increased compared with the prior year period, the flat daily fee per stock for quotation or

messaging combined with a concentration of activity within a small number of stocks meant that revenues did not benefit. These factors combined to produce the 5% decline shown above for segmental revenues in the quarter.

Corporate Services data show the reduction in the number of OTCQX clients (8%) compared with last year, with the main factor here being the downgrading of 54 companies for compliance reasons. While negative for near-term revenues, OTCM sees enhancing the standards for its OTCQX market as important in increasing its reputation and recognition by state regulators. This should in turn be positive on a longer-term view. Sales have been stronger year to date with a total of 58 new companies added for the first nine months compared with 40 in the same period in 2016. OTCQB has continued to make net additions to its corporate client list (+6%) reflecting strong sales and reduced churn.

Within Market Data Licensing professional user numbers were down by 7%, which OTCM notes probably represents normal fluctuation due to user audits and numbers reported by redistributors. As in Q217, the number of non-professional users increased strongly against the prior year period. Sequentially, there was a marked reduction, suggesting this part of the user base may prove more volatile than professional users, but it accounts for less than 10% of segment revenues compared with over 50% for professional users.

Exhibit 2: Operating and related revenue data						
\$000s	Q316	Q117	Q217	Q317	% change vs Q316	% change vs Q217
OTC Link ATS						
Number of securities quoted	9,644	9,638	9,562	9,991	3.6	4.5
Number of active participants	108	99	97	94	(13.0)	(3.1)
Revenue per security quoted (\$)	262	272	261	242	(7.9)	(7.5)
Revenue per average active participant (\$)	23,000	25,541	25,480	25,267	9.9	(0.8)
Revenue bps of volume traded	0.54	0.47	0.45	0.45	(16.9)	0.3
Corporate Services						
Number of corporate clients						
OTCQX	387	363	355	355	(8.3)	0.0
OTCQB	869	928	912	923	6.2	1.2
Pink	693	676	722	727	4.9	0.7
Total	1,949	1,967	1,989	2,005	2.9	0.8
Revenue per client (\$)	2,467	2,699	2,891	2,845	15.3	(1.6)
Market Data Licensing						
Market data professional users	22,096	20,700	20,625	20,512	(7.2)	(0.5)
Market data non-professional users	11,472	16,022	16,204	14,012	22.1	(13.5)
Revenue per terminal (total)	157	148	150	159	1.5	6.3
Source: OTCM, Edison Investment Research						

In its Q3 release OTCM made a number of announcements that relate to its long-term aim to increase the reputation of its premium markets, and provide a range of services to its users, corporate or broker dealer. These included the addition of two further states that recognise OTCM markets for Blue Sky purposes, new participants in the Transfer Agent Verified Shares Program, the establishment of alliances with the Canadian Securities Exchange (CSE) and Issuer Direct Corporation (ISDR) and the expected launch of OTC Link ECN (Electronic Communication Network) before the end of the year. Further, confirming the continuing work to maintain the resilience of its system, OTC Link ATS recorded a further quarter of 100% uptime during trading hours, important given its status as a Regulation Systems Compliance and Integrity (SCI) entity.

Exhibit 3 shows the list of states with **Blue Sky recognition** for OTCM markets. During the third quarter two more states, Hawaii and Pennsylvania (the latter under existing law), joined the list. This brought the number of states where OTCQX securities were qualified for secondary trading at the end of October to 27 and for OTCQB to 24. There was also encouraging news in that the North American Securities Administrators Association (NASAA) is planning to issue a model rule recognising OTCQX and OTCQB markets under a manual exemption. While the model rule has yet

to be issued and the impact of having it available is uncertain, it may encourage states where resources to deal with such issues are constrained to take the necessary steps to give recognition.

Exhibit 3: Blue Sky recognition for OTCQX and OTCQB

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

Source: OTCM. Note: The two new states added since Q217 announcement are in bold.

The **Transfer Agent Verified Shares Program** assembles data on share issuance, increasing transparency in relation to dilutive share issuance, for example. The number of participating share transfer agents has increased from 12 as reported at the Q2 stage to 15.

The strategic alliance with the **Canadian Stock Exchange** means that international corporates can seek a Canadian listing and raise funds through CSE and then develop secondary trading in the US through OTCQX or OTCQB in a cost-effective manner.

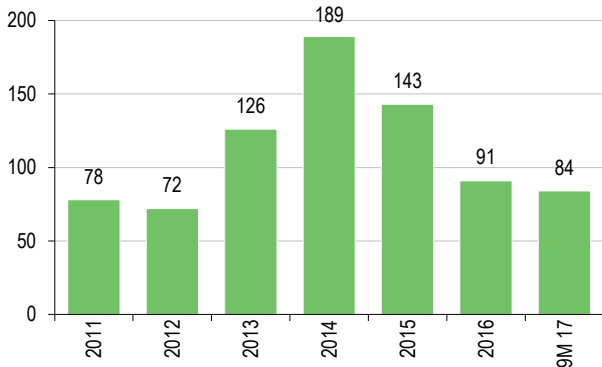
The alliance with **Issuer Direct** means that corporate clients of OTCM can more easily access the communications and compliance services offered by ISDR, helping to make being public “less painful”, particularly for smaller companies that may not wish to devote the resources that would otherwise be required to these functions.

The launch of **OTC Link ECN** will provide an additional option for OTCM’s broker-dealer subscribers by providing an anonymous trading platform with a matching engine and liquidity router for selected OTC equities. We assume broker-dealers with their own internal matching systems are unlikely to divert substantial business to the new ECN but will continue to seek the liquidity provided by market makers through the existing OTC Link ATS quotation platform. However, the ECN will provide an alternative for other participants. OTCM notes that the ECN has been created in a cost-efficient manner and that it has interest from some subscribers but notes that it is not possible to anticipate the rate of adoption. From a competitive perspective, Global OTC (subsidiary of NYSE) has recently adopted a fully attributable quoting model with maker-taker pricing under which incentives are offered to liquidity suppliers. This has yet to have a noticeable impact on Global OTC’s market share, which has fluctuated between 7.4% and 11.9% year to date (latest reading c 9%). It remains to be seen what pricing model OTC Link ECN will adopt.

Current trading environment and outlook

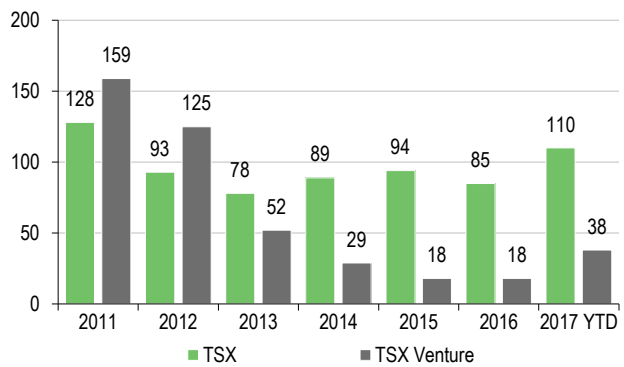
We monitor IPO volumes for Nasdaq and the Canadian TSX and TSX Venture exchanges as indicators of the health of issuer activity in North America. As Exhibits 4 and 5 show, the first nine months (Nasdaq) and year to October (TSX markets) have shown a healthy trend with the number of IPOs on the Canadian markets already outpacing 2016 by a comfortable margin.

Exhibit 4: Nasdaq – number of IPOs



Source: Nasdaq

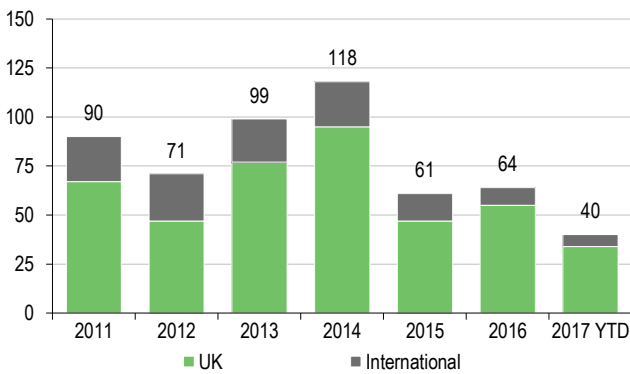
Exhibit 5: TSX and TSX Venture – number of IPOs



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

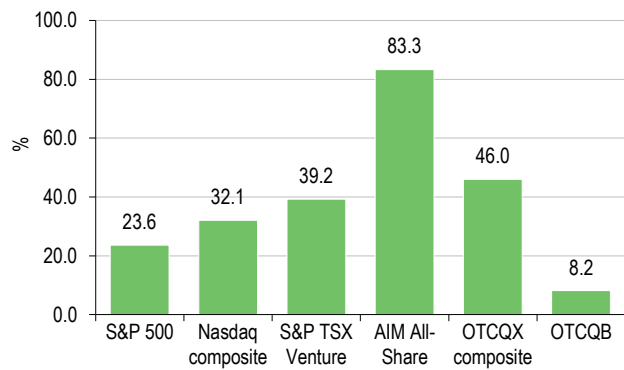
As with Nasdaq, in the UK the run rate for AIM is ahead of the prior year period (Exhibit 6). Despite geopolitical uncertainties globally, the economic background has remained positive and global GDP forecasts have followed an upward trend. This has probably underpinned the strongly positive market performances shown in Exhibit 7.

Exhibit 6: AIM number of admissions



Source: AIM. Note: Ytd to end October.

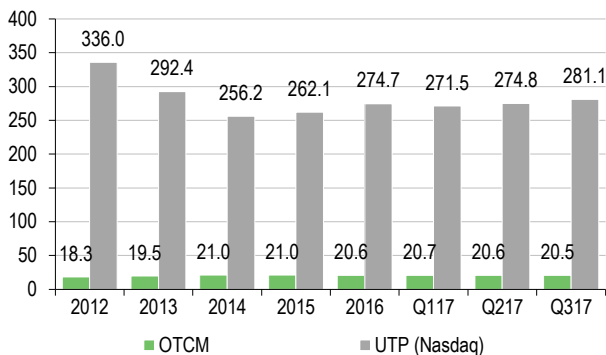
Exhibit 7: One-year index performance (US\$ terms)



Source: Bloomberg. Note: Total return, to 8 November 2017.

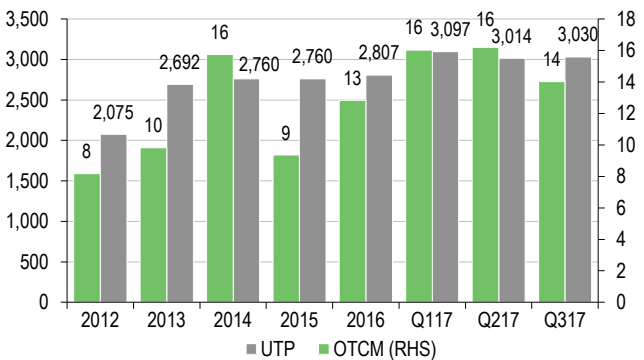
While this creates what would normally be seen as a positive background for new listings, there have been reports of a number of IPO cancellations seemingly reflecting a lack of investor appetite. Perhaps high valuations (for example in the US the cyclically adjusted price earnings ratio is standing 25% above its 10-year average) and unusually low volatility, as represented by the VIX, are restraining factors here.

Exhibit 8: OTCM and UTP (Nasdaq) professional users



Source: OTCM, UTP Plan, Edison Investment Research (000s)

Exhibit 9: OTCM and UTP non-professional users



Source: OTCM, UTP Plan, Edison Investment Research (000s)

Exhibits 8 and 9 set the recent data user figures in a longer-term context and also give figures for UTP (Nasdaq). This shows that OTCM still has a small share of the market compared with UTP (Q317 7.3% of professional users), suggesting the potential for gains assuming the premium markets can continue to broaden their client base and increase their profile.

For OTC Link ATS, the trading environment seems likely to remain challenging in the near to medium term as broker dealers continue to face unfavourable trading conditions. For the moment we have not factored in an explicit impact from the launch of OTCM's ECN and the main near-term factor that could produce a marked uptick in this area would be a volatility-driven increase in trading levels.

More broadly, OTCM continues to work on making its markets more business friendly and transparent for investors. Efforts to encourage further states to grant Blue Sky recognition are being maintained. Even if there is no direct linkage to revenue generation there should be reputational benefits as Blue Sky recognition is extended. The company remains optimistic on the broadening of the universe of potential corporate clients as crowdfunding and online funding gain traction following the JOBS Act (including Regulation A+). To this end OTCM is encouraged that the House of Representatives passed the Improving Capital Access Act in September; the next step will be consideration of the bill by the Senate. Passage into law would allow SEC reporting companies to offer securities under Regulation A+.

Financials

There are only modest changes to our estimates following the Q317 results. Within revenues we have increased our estimate for Corporate Services for FY18, reflecting the implementation of a 20% fee increase for OTCQB companies. Against this we have adopted a slightly more conservative assumption for OTC Link ATS given the continuing reduction in the number of active participants. Operating expense estimates are marginally increased to allow for headcount and other spending to support new services. For FY17 our pre-tax profit estimate falls slightly but earnings per share rise, benefiting from the one-off tax reduction seen in Q3. FY18 sees a smaller benefit from ongoing tax savings. Our dividend assumptions are reduced to reflect the payments already announced for FY17 and hence a lower base for FY18.

Exhibit 10: Earnings revisions												
	Gross revenue (\$m)			PBT (\$m)			EPS (\$)			Dividend (\$)		
	Old	New	Change	Old	New	Change	Old	New	Change	Old	New	Change
2017e	54.8	54.4	-1%	18.7	18.3	-2%	1.03	1.06	3.1%	1.20	1.16	-3%
2018e	57.2	57.6	1%	19.5	19.8	1%	1.06	1.07	1.4%	1.22	1.19	-2%

Source: Edison Investment Research

Valuation

We have updated our usual comparative P/E table including 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 (Exhibit 11). As previously, OTCM trades on multiples below and similar to the consensus averages for the exchanges and information providers for FY17 and FY18 respectively. Changes in the level of trading activity prompted by market volatility could help near-term revenues for OTC Link ATS, but on a longer view the main potential drivers of positive earnings surprises and hence valuation would be a broadening population of potential corporate clients and progressive increases in the reputation and traction of the OTCQX and OTCQB markets, as discussed above.

Exhibit 11: OTCM comparative multiples

	Estimated P/E ratios (x)	
	FY17e	FY18e
MSCI	32.5	27.3
Markit	20.8	19.3
Average information providers	26.7	23.3
Average global exchanges	25.1	21.3
S&P 500	19.2	17.5
OTCM	23.1	22.8

Source: Bloomberg, Edison Investment Research. Note: Prices as at 15 November 2017.

Using a discounted cash flow model based on our current estimates and adjusting assumptions to match the current share price (\$24.5 on 15 November 2017), one combination producing this value would be a discount rate of 10.5%, a long-term growth rate of 3.5% and a terminal multiple of 16.5x (compares with a current year value of 16.9x). A sensitivity table below shows how the DCF valuation changes with discount rate and growth assumptions. Given the limited change in estimates and the similarity of rating relative to peers, we retain c \$26 as a fair value estimate.

Exhibit 12: Discounted cash flow valuation sensitivity (\$ per share)

Discount rate (right)	7%	8%	9%	10%	11%
2019-27e growth					
2%	28.5	26.7	25.0	23.5	22.2
3%	30.2	28.3	26.5	24.9	23.4
4%	32.1	30.0	28.1	26.4	24.8
5%	34.1	31.9	29.8	27.9	26.2

Source: Edison Investment Research

Exhibit 13: Financial summary

\$000s (US GAAP)	2015	2016	2017e	2018e
Year end 31 December				
PROFIT & LOSS				
OTC Link ATS	11,796	10,573	9,878	9,582
Market Data Licensing	20,610	21,054	21,977	22,966
Corporate Services	17,503	19,254	22,562	25,044
Revenue	49,909	50,881	54,417	57,591
Re-distribution fees and rebates	(2,379)	(2,317)	(2,424)	(2,525)
Net revenue	47,530	48,564	51,993	55,066
Operating expenses	(28,972)	(30,032)	(32,337)	(33,857)
EBITDA	18,558	18,532	19,656	21,210
Depreciation	(1,692)	(1,606)	(1,394)	(1,422)
Operating profit	16,866	16,926	18,262	19,788
Net interest	27	9	46	20
Profit Before Tax (norm)	16,893	16,935	18,308	19,808
Tax	(6,635)	(6,407)	(5,619)	(6,933)
Profit after tax (FRS 3)	10,258	10,528	12,689	12,875
Profit after tax (norm)	9,971	11,993	12,364	12,550
Fully diluted av. No. of shares (m)	11.3	11.3	11.6	11.7
EPS - normalised (c)	88.3	105.8	106.2	107.2
Fully diluted EPS - FRS 3 (c)	90.6	108.1	108.5	109.6
Dividend per share (c)	108.0	116.0	116.0	119.0
EBITDA Margin (%)	39	38	38	39
Operating profit margin (%)	35	35	35	36
BALANCE SHEET				
Non-current assets				
Intangible assets	291	291	400	500
Property and other	4,187	3,267	3,224	2,442
Current assets				
Debtors				
Cash & cash investments	23,925	25,034	25,646	28,083
Other current assets	1,729	1,789	1,849	1,849
Current liabilities				
Deferred revenues	(12,737)	(14,664)	(15,200)	(16,000)
Other current liabilities	(5,063)	(5,372)	(5,974)	(5,974)
Long-term liabilities				
Tax, rent and other	(867)	(1,101)	(1,343)	(1,343)
Net assets	17,547	15,506	14,249	15,204
NAV per share (\$)	1.55	1.36	1.25	1.32
CASH FLOW				
Operating cash flow	22,400	21,752	21,911	23,661
Net Interest	27	9	46	20
Tax	(5,320)	(6,021)	(4,696)	(6,933)
Capex/intangible investment	(940)	(415)	(861)	(740)
Financing/investments	(420)	(1,157)	(2,545)	0
Dividends	(12,094)	(13,059)	(13,243)	(13,572)
Net cash flow	3,653	1,109	612	2,436
Opening net (debt)/cash	20,272	23,925	25,034	25,646
Closing net (debt)/cash	23,925	25,034	25,646	28,083

Source: OTC Markets Group accounts, Edison Investment Research

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