OTC Markets Group

Q218 results

Progress continues

Financial services

OTC Markets Group's (OTCM) second-quarter result was ahead of our expectation, in part because of favourable market trading volumes. While these volumes may not be sustained, underlying progress in terms of further regulatory recognition, successful launch of the ECN platform, encouraging sales of enhanced data products and a lengthening record of 100% uptime in core systems all point to a strengthening of the business over time. Given this and modest estimate increases, we have raised our fair value to c $31.

Year end	Revenue ($m)	PBT ($m)	EPS* ($)	DPS** ($)	P/E (x)	Yield (%)
12/16	50.9	16.9	0.90	1.16	32.1	4.0
12/17	54.7	18.4	1.06	1.16	27.4	4.0
12/18e	58.2	19.5	1.31	1.20	22.1	4.1
12/19e	60.7	20.6	1.36	1.25	21.3	4.3

Note: *Fully diluted and calculated after restricted stock award allocation. **Including special declared dividends of $0.60 for 2016 and 2017, and an estimated $0.61 and $0.65 for 2018 and 2019, respectively.

Q218 results

Second-quarter revenue growth was 7% versus Q217, within which OTC Link was up 12%, reflecting buoyant trading levels and the contribution from OTC Link ECN, which continues to gain traction. Market Data Licensing and Corporate Services were ahead by 6% and 7%, respectively, with new data products and selective price increases being factors in the growth. Higher compensation and advisory costs contributed to a 9% increase in expenses and pre-tax profit was therefore up by 3%. Diluted EPS benefited from the lower tax charge that applies this year and this resulted in a 28% increase to $0.34. The quarterly dividend payment has been raised to $0.15 from $0.14.

Market background and outlook

Uncertainties over the macro background remain a factor that could put a brake on corporate confidence and trading activity levels on equity exchanges. Having said that, the US economy remains robust, contributing to a generally favourable background for OTCM's activities. Reputationally, continued growth in the number of states granting OTCM markets Blue Sky recognition and the announcement by the North American Securities Administrators Association (NASAA) of a model rule are both positive factors. The passage of legislation in May, extending the availability of Reg A+ to SEC reporting companies, should deepen the pool of potential corporate customers for OTCM over time.

Valuation: Estimates and valuation raised

OTCM trades modestly below the average P/Es for exchanges and information providers. Taking this into account, together with the progress being made in the business and small estimate increases, we have raised our fair value to c $31 versus $29 previously (see page 6 for further discussion).

24 August 2018

Price	**US$29.00**
Market cap	**US$335m**

Net cash ($m) at end June 2018	25
Shares in issue	11.5m
Free float	61%
Code	OTCM
Primary exchange	OTCQX
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	(0.7)	7.4	17.7
Rel (local)	(2.4)	2.8	0.7
52-week high/low		US$32	US$23

Business description

OTC Markets Group operates the OTCQX, OTCQB and Pink financial markets for over 10,000 US and global securities. OTC Link LLC, a member of FINRA, operates OTC Link ATS and OTC Link ECN, both SEC-registered Alternative Trading Systems. Approximately 85% of revenues are of a contract-based recurring nature.

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Q218 results analysis

OTCM's Q218 gross revenue increased by just over 7% versus Q217, in line with the growth reported for the first quarter. There was a slightly higher growth in fees and rebates, including those paid out for liquidity providers on the OTC Link ECN as it gains traction. Operating expenses also outpaced revenues, partly boosted by one-off costs related to a potential acquisition that did not proceed. This resulted in pre-tax profit growth of 3.3%, which, after a sharp reduction in the tax rate, translated into diluted EPS growth of 27.6% to 34 cents. The quarterly dividend (39th consecutive payment) has been increased from 14 to 15 cents (+7%).

Exhibit 1: Q218 results summary

$000s (except where stated)	Q217	Q317	Q417	Q118	Q218	y-o-y (% chg)	q-o-q (% chg)
OTC Link	2,497	2,413	2,546	2,651	2,799	12.1	5.6
Market data licensing	5,522	5,505	5,445	5,842	5,830	5.6	(0.2)
Corporate services	5,750	5,704	5,898	5,849	6,137	6.7	4.9
Gross revenues	**13,769**	**13,622**	**13,889**	**14,342**	**14,766**	**7.2**	**3.0**
Re-distribution fees and rebates	(626)	(584)	(646)	(629)	(710)	13.4	12.9
Net revenue	**13,143**	**13,038**	**13,243**	**13,713**	**14,056**	**6.9**	**2.5**
Operating expenses	(8,319)	(8,448)	(8,591)	(9,163)	(9,060)	8.9	(1.1)
Income from operations	4,824	4,590	4,652	4,550	4,996	3.6	9.8
Other income / net interest	22	5	6	17	11	(50.0)	(35.3)
Income before provision for income taxes	**4,846**	**4,595**	**4,658**	**4,567**	**5,007**	**3.3**	**9.6**
Taxes	(1,741)	(1,107)	(1,742)	(820)	(1,020)	(41.4)	24.4
Net income	3,105	3,488	2,916	3,747	3,987	28.4	6.4
Diluted EPS $	**0.26**	**0.29**	**0.24**	**0.31**	**0.34**	**27.6**	**6.5**
Operating margin	37%	35%	35%	33%	36%		
Tax rate	36%	24%	37%	18%	20%		

Source: OTCM, Edison Investment Research

Focusing on the **revenue figures**, we can see that OTC Link recorded the most rapid segmental growth. This follows three years in which revenues declined as the number of broker-dealer participants continued to contract in the face of difficult market conditions, which have prompted withdrawals and consolidation. Positive features in the quarter included a contribution of $0.2m from the ECN, which is already covering its direct costs. High transaction levels drove messaging income up, which more than outweighed a year-on-year decline in subscription revenues. We note that sequentially there was actually one additional participant following previous contraction and three quarters of stability (see operating data in Exhibit 2).

Market data licensing growth (6%) resulted from a combination of new sales of data licence products (including compliance products in particular), price increases and signing up new broker-dealer licences. Through development, compliance products appear to have reached a point of self-reinforcing acceptance among broker-dealers, banks and custodians. In the operating data, we can see that the number of professional users has risen for the second quarter in a row and now stands just above the average level for the period since the beginning of 2015.

Corporate services revenue increased by 7% with the main driver being OTCQB, where there was a slightly higher number of companies in the quarter versus Q217 and higher prices for subscribers that were implemented at the beginning of 2018. Sequentially, the number of OTCQB companies actually fell modestly, reflecting a weaker level of sales and higher churn. OTCQX revenue also made progress, benefiting from a higher number of companies both year-on-year and sequentially resulting from stronger sales. Churn among the OTCQX corporate clients generated accelerated revenue recognition, which also bolstered revenue.

Exhibit 2: Operating and related revenue data

	Q217	Q317	Q417	Q118	Q218	y-o-y % chg	q-o-q % chg
OTC Link ATS							
Number of securities quoted	9,562	9,991	10,286	10,448	10,476	9.6	0.3
Number of active participants	97	94	94	94	95	(2.1)	1.1
Revenue per security quoted ($)	261	242	248	254	267	2.3	5.3
Revenue per average active participant ($)	25,480	25,267	27,085	28,202	29,619	16.2	5.0
Corporate Services							
Number of corporate clients							
OTCQX	355	355	366	358	365	2.8	2.0
OTCQB	912	923	938	951	922	1.1	(3.0)
Pink	722	727	755	756	761	5.4	0.7
Total	1,989	2,005	2,059	2,065	2,048	3.0	(0.8)
Revenue per client ($)	2,891	2,845	2,864	2,832	2,997	3.7	5.8
Graduates to a national securities exchange	14	12	24	21	20	42.9	(4.8)
Market Data Licensing							
Market data professional users	20,625	20,512	20,390	20,557	20,951	1.6	1.9
Market data non-professional users	16,204	14,012	14,801	15,726	15,389	(5.0)	(2.1)
Revenue per terminal (total - $)	150	159	155	161	160	7.0	(0.4)

Source: OTCM, Edison Investment Research

Within an overall increase of 9% in **expenses** versus Q217, the main features were a 12% rise in compensation costs, a sharp rise in advisory fees, as noted above, and a reduction in depreciation and amortisation. The compensation cost increase reflected higher headcount, salary increases and incentive accrual, while depreciation was lower following full depreciation of leasehold improvements at the end of 2017.

The group incurred costs in the period arising from consideration of **a potential acquisition**, which did not proceed. While OTCM has not given any details on the possible purchase, it indicates that it is part of its strategy to look for opportunities to add businesses that provide products and services to its client base including, for example, the small- and mid-cap issuer area. We assume this could include targets that are larger than transactions that have taken place so far but would be subject to fit, integration risks and prospective return on capital. As an illustration, if we were to assume an acquisition with a consideration of $50m, at a revenue multiple of four times with an EBITDA margin of 30% and which is 80% financed by debt, then this could result in a debt/EBITDA multiple of 1.7x, interest cover of over 11x, remaining cash of $16m and an 8% increase in pre-tax profit before allowing for any cost or revenue synergies.

The list of states that grant **Blue Sky recognition** to OTCQX or OTCQB continues to grow with Minnesota added in the latest quarter, bringing the total number of states to 31 (see full list in Exhibit 3). In terms of population coverage, this takes OTCM to nearly 47%. There are a further three states in the process of considering giving recognition (Michigan, Missouri and Oklahoma) and if they were all to proceed this would increase the population coverage to 53%.

On this front, an encouraging development in July was the announcement by the NASAA of a model rule for states to employ that would have the effect of granting OTCQX/QB recognition. The period for comments ended 20 August and the NASAA is considering responses before deciding on any amendments or adoption. OTCM notes that adoption should facilitate a number of states moving towards granting Blue Sky recognition to its markets.

The continued increase in the number of states granting Blue Sky recognition to OTCM premium markets does not directly lead to revenue gains, but is helpful in terms of reputation with potential corporate clients, while every addition (and adoption of the model rule by NASAA) is likely to ease the process of winning over further states.

Exhibit 3: Blue Sky recognition for OTCQX and OTCQB

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

Source: OTCM

The passage of the Economic Growth, Regulatory Relief, and Consumer Protection Act (S.2155) in May is set to extend the availability of **Regulation A+** to SEC reporting companies. (Regulation A+ allows companies to raise up to $50m in a 12-month period through a public solicitation with lower regulatory hurdles and costs.) The impact of S.2155 is dependent on the detail of SEC rule changes and the appetite of potential issuers. However, it may enlarge the pool of companies offering securities using Regulation A+ and would be likely to add more established companies and hence tend to improve the reputation of this route to raising equity capital. As with increasing Blue Sky recognitions, there is no direct benefit to OTCM from the change in legislation but any move that progressively raises the population of corporates likely to seek a cost-effective venue for secondary trading in their shares could be increasingly helpful.

There was further progress in the quarter in OTCM's drive to enhance transparency and data availability for market users. The **Transfer Agent Verified Shares Program** (provides timely information on share issuance/share count) has continued to increase coverage with 22 agents now participating, representing 85% of US companies on OTCQX and OTCQB. In addition to the stock promotion flag introduced in Q118, a **stock promotion data file** was made available to market participants with the compliance data file also updated to include this and shell risk information, another flag introduced in the first quarter.

Background and outlook

Following a correction in February, the broader equity market context has been generally positive over the past three and six months, although smaller cap/venture company biased indices and the two OTCM markets have shown some weakness (see Exhibit 4).

Exhibit 4: Recent market index performance (total return %)

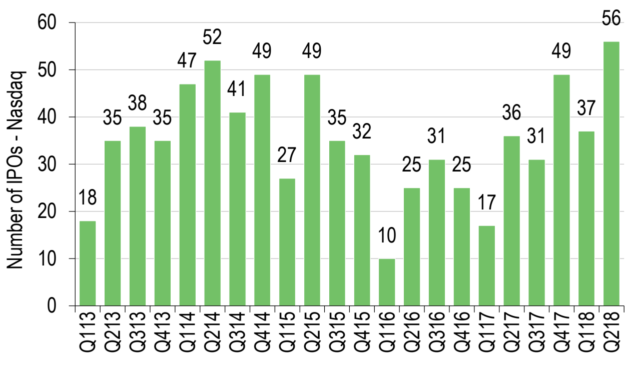
Period	S&P 500	Nasdaq Composite	OTCQX Composite	OTCQB	S&P TSX Venture	AIM All Share
	US$	US$	US$	US$	C$	GB£
3m	4.9	5.8	(3.8)	(6.2)	(13.8)	(0.4)
6m	5.0	8.4	(3.4)	(13.3)	(18.8)	4.5
1y	17.3	24.4	20.0	(11.7)	(12.3)	8.9
Year to date	7.6	13.9	(6.2)	(19.4)	(20.8)	3.5

Source: Bloomberg. Note: priced 16/8/18.

This would suggest a somewhat mixed background for corporate activity and hence for OTCM clients and potential clients. However, the read-across is not direct and looking at the new issuance activity levels for Nasdaq and TSX Venture exchanges in the first half (Exhibits 5 and 6), we can see that they have enjoyed a strong period for the first half of the year with the number of IPOs up 75% and over 150%, respectively, compared with H117. TSX activity has been more subdued (-5%).

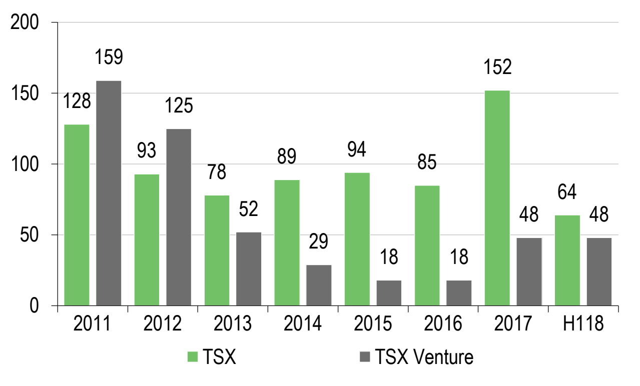
Absent a significant spike in equity market volatility (the Cboe VIX remains at relatively subdued levels) and with economic activity in the US remaining robust, the conditions for corporate activity and for OTCM to recruit corporate subscribers to its markets appear satisfactory or favourable.

Exhibit 5: Nasdaq – number of IPOs



Source: Nasdaq

Exhibit 6: TSX and TSX Venture – number of IPOs



Source: TMX

For OTCM itself, there are a number of specific considerations that may have a bearing on the outlook, including the following.

- Adoption of the NASAA rule proposal and further states granting Blue Sky recognition would be positives.
- Detailed SEC rules implementing S.2155 could be more or less favourable for the longer-term impact of this legislation.
- The level of international corporate interest in using OTCM markets is an important factor for new client wins/churn.
- Market data revenue could continue to benefit from compliance file enhancements and acceptance.
- OTC Link may benefit from continued stability in the number of active participants but renewed erosion would act as a brake on OTC Link subscription revenues (estimated to be less than 5% of group total revenue) and could also affect broker-dealer subscriptions for market data.
- OTC Link ECN revenues or rebates could be affected if the company decides to lower fees or increase rebates in order to retain or increase market share. We note here that there has not been a significant change in market share for competitor Global OTC, which has recently hovered around 10%.
- Expenses for FY19 are likely to be affected by the notice OTCM received in July of an amended expiry date for the lease agreement relating to its main office in New York (now end-January 2019 rather than June 2020 previously). As the rental was relatively inexpensive, the cost of the new office is likely to be higher and there will be some capital spending associated with fitting out the new office.

In the next section, we highlight changes in our estimates and comment on the group's financial position.

Financials

Reflecting the performance year-to-date, we have edged up our revenue estimates for both years, with the main change being in OTC Link where performance has been ahead of our expectation, and we now assume a marginal increase next year rather than a decline.

Occupancy costs are set to rise in FY19 with the move to a new office in New York. We have allowed for an increase of 20% or approaching $0.4m in this area. Overall expenses, including depreciation and amortisation, are expected to increase by c 6% this year, partly affected by the M&A-related fees mentioned earlier, and by c 4% next year, assuming no M&A costs.

The net result is that our pre-tax profit estimate for this year increases by just over 1% and is virtually unchanged for next year. At the EPS level, our assumption of a slightly lower tax rate than before (20%, in line with Q218) produces modest estimate increases of 1.7% and 1.3% for this year and next. We continue to include special dividends in our estimates but note that significant investment in an acquisition (not in our estimates) could constitute an alternative use of funds.

Exhibit 7: Estimate revisions

	Gross revenue ($m)			PBT ($m)			EPS ($)			Dividend ($)		
	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)
2018e	57.3	58.2	1.6	19.2	19.5	1.2	1.29	1.31	1.7	1.19	1.20	0.8
2019e	60.1	60.7	1.0	20.5	20.6	0.1	1.35	1.36	1.3	1.24	1.25	0.8

Source: Edison Investment Research. Note: Dividends include estimated special dividends

The cash available for operations at the end of June was $25.0m compared with $22.7m at end-March and $23.7m at the end of 2017. This excluded $0.7m of restricted cash held as clearing collateral. Cash flow in the quarter was seasonally stronger following the normal incidence of bonus payments in the first quarter. Capital spending remained at a relatively low level but we assume that this simply reflects timing and that spending will be higher in the second half, potentially boosted by expenditure required ahead of the office move. Despite this and our assumption of a special dividend payment, we still look for year-end cash available for operations of c $26m.

Valuation

Our comparative valuation table (Exhibit 8) includes information providers, MSCI and Markit, given the data/subscription emphasis within OTCM's revenues as well as the average rating for global exchanges (which also generate significant data-related revenues). This shows that OTCM trades on prospective P/E ratios below both groups for FY18e and in line with exchanges and below information providers for FY19e.

Exhibit 8: OTCM comparative multiples

	Estimated P/E ratios (x)	
	FY18e	FY19e
MSCI	32.9	28.6
Markit	23.6	20.9
Average information providers	**28.2**	**24.7**
Average global exchanges	**23.7**	**21.0**
S&P 500	17.7	16.0
OTCM	**22.1**	**21.3**

Source: Bloomberg, Edison Investment Research. Note: Prices as at 23 August 2018.

As previously, we have adjusted the assumptions within our discounted cash flow model to match the share price at the time of writing ($29.00, 23 August 2018) and one combination that gives this value is a discount rate of 10%, a long-term growth rate of 4.0% and a terminal operating cash flow multiple of 16.0x (compares with a current year value of 19.0x). These assumptions do not appear aggressive and, with a small increase in estimates and encouraging developments within the business, we have increased our fair value estimate to c $31 from $29. The sensitivity of our valuation to discount rate and growth assumptions is shown in Exhibit 9.

Exhibit 9: Discounted cash flow valuation sensitivity ($ per share)

Discount rate (right) 2020-28e growth	8%	9%	10%	11%	12%
3%	31.5	29.4	27.5	25.8	24.2
4%	33.4	31.2	29.1	27.3	25.6
5%	35.5	33.1	30.9	28.8	27.0
6%	37.7	35.1	32.7	30.5	28.6

Source: Edison Investment Research

Exhibit 10: Financial summary

$000s	2015	2016	2017	2018e	2019e
Year end 31 December					
PROFIT & LOSS					
OTC Link	11,796	10,573	10,074	10,650	10,813
Market Data Licensing	20,610	21,054	21,922	23,272	24,450
Corporate Services	17,503	19,254	22,660	24,286	25,475
Revenue	49,909	50,881	54,656	58,208	60,738
Re-distribution fees and rebates	(2,379)	(2,317)	(2,480)	(2,736)	(2,915)
Net revenue	47,530	48,564	52,176	55,472	57,822
Operating expenses	(28,972)	(30,032)	(32,511)	(35,000)	(36,225)
EBITDA	18,558	18,532	19,665	20,472	21,597
Depreciation	(1,692)	(1,606)	(1,361)	(1,063)	(1,080)
Operating profit (before amort. and except).	16,866	16,926	18,304	19,409	20,517
Net interest	27	9	47	42	38
Profit Before Tax (norm)	16,893	16,935	18,351	19,451	20,555
Tax	(6,635)	(6,407)	(5,792)	(3,815)	(4,111)
Profit after tax	10,258	10,528	12,559	15,636	16,444
Profit after tax and allocation to RSAs	9,971	10,252	12,241	15,252	16,056
Average Number of Shares Outstanding (m)	11.3	11.3	11.6	11.6	11.8
EPS - normalised (c)	90.6	92.4	109.9	133.9	139.2
Fully diluted EPS (c)	88.3	90.4	105.8	131.1	136.2
Dividend per share (c)	108.0	116.0	116.0	120.0	125.0
EBITDA Margin (%)	39	38	38	37	37
Operating profit margin (%)	35	35	35	35	35
BALANCE SHEET					
Non-current assets					
Intangible assets	291	291	362	337	337
Property and other	4,187	3,267	3,506	3,335	3,110
Current assets					
Debtors	6,082	6,262	6,450	6,064	6,064
Cash & cash investments	23,925	25,034	23,683	26,043	31,090
Other current assets	1,729	1,789	2,316	2,060	2,160
Current liabilities					
Deferred revenues	(12,737)	(14,664)	(15,531)	(16,000)	(16,500)
Other current liabilities	(5,063)	(5,372)	(5,644)	(4,088)	(4,088)
Long-term liabilities					
Tax, rent and other	(867)	(1,101)	(1,351)	(1,287)	(1,287)
Net assets	17,547	15,506	13,791	16,464	20,886
NAV per share ($)	1.55	1.36	1.21	1.43	1.81
CASH FLOW					
Operating cash flow	22,400	21,752	21,629	20,966	24,497
Net Interest	27	9	47	42	38
Tax	(5,320)	(6,021)	(5,193)	(2,386)	(4,111)
Capex / intangible investment	(940)	(415)	(1,165)	(974)	(855)
Financing / investments	(420)	(1,157)	(3,407)	(1,567)	(100)
Dividends	(12,094)	(13,059)	(13,262)	(13,720)	(14,422)
Net cash flow	3,653	1,109	(1,351)	2,360	5,047
Opening net (debt)/cash	20,272	23,925	25,034	23,683	26,043
Closing net (debt)/cash	23,925	25,034	23,683	26,043	31,090

Source: OTC Markets Group accounts, Edison Investment Research. Note: Cash excludes restricted cash.

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