OTC Markets Group

Q113 results

Steady as she goes

Financial services

OTCM's (OTCQX: OTCM) Q113 results showed diversification benefits. Total revenue grew 1% on Q112, with a rise in market data licensing and issuer services offsetting a fall in trading service revenue. A continued limited market demand for resource companies has seen slower than usual OTCQX customer acquisition and led us to cut our estimates. Investors are likely to appreciate the above-forecast dividend increase.

Year end	Revenue ($m)	PBT* ($m)	EPS* (c)	DPS (c)	P/E (x)	Yield (%)
12/11	30.8	7.0	0.45	0.16	18.8	1.9
12/12	33.2	9.0	0.51	0.45**	16.6	5.3
12/13e	35.5	9.2	0.50	0.24	16.9	2.8
12/14e	38.8	10.3	0.56	0.28	15.1	3.3

Note: *PBT and EPS are diluted and adjusted for the effects of restricted stock awards. **Includes special dividend.

Benefit of revenue diversification

In recent years, management has developed a range of new products, improving revenue sustainability. The benefits were seen in Q113, with increases in market data licence subscription and issuer services offsetting a 5% decline in trading services, which saw lower dealer licences, connection fees and subscriptions as the smaller broker-dealer community contracted following weak trading volumes. Despite the variable market conditions, OTCM has grown revenue every year since 2007 and we expect this to continue over the forecast period.

Issuer Services – slower growth

Issuer services' annual renewal takes place in January and an above-average 13% did not renew this year, which we believe primarily reflects the lower market appetite for resource companies. Q113 divisional revenue was up 9%, as the lower renewal rate only partially offset the growth in customers in H112. Looking forward, slower than recently experienced new customer acquisition means the Q2-Q4 comparators will become increasingly challenging and we have cut our estimates accordingly. Management's objectives are to increase the flow of new business, diversify the issuer industrial sectors and slow down non-renewals, and we expect a number of initiatives to be delivered during 2013.

Management confidence in investment and dividend

The sustainability of income means management can invest in the business. Q113 saw profit and loss investment in ongoing programmes to upgrade IT and data centres, intended to deliver a more scalable network and facilitate new product delivery. Marketing and advertising was below the annual run rate due to the timing of initiatives. The dividend was raised 20% to 6c, showing management confidence.

Valuation: Fair value $9.8

Our average valuation approaches indicate a fair value of $9.8, down on our previous estimates ($10.7) given the reduction in forecasts.

20 May 2013

Price	**US$8.45**
Market cap	**US$92m**

Net debt/cash ($m)	12.3
Shares in issue	10.8m
Free float	59%
Code	OTCM
Primary exchange	OTCQX

Share price performance

%	1m	3m	12m
Abs	5.6	5.9	26.1
Rel (local)	(1.7)	(3.5)	(1.3)
52-week high/low		US$8.4	US$6.4

Business description

OTC Markets Group (OTCM) operates a marketplaces platform directly linking a diverse network of broker-dealers that provide liquidity and execution services in almost 10,000 equity and debt securities. OTC LINK ATS is an SEC-registered Alternative Trading System (ATS).

Next events

H1 results	August 2013

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Edison profile page

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Q113 results

Exhibit 1: Quarterly profit and loss account ($000s)

	Q112	Q113	Growth
Trading services	3,014	2,850	-5%
Market data licensing	3,523	3,567	1%
Issuer services	2,031	2,208	9%
Gross revenues	**8,568**	**8,625**	**1%**
Re-distribution fees and rebates	(484)	(475)	-2%
Net revenue	**8,084**	**8,150**	**1%**
Operating expenses (exc depreciation and amortisation)	(5,543)	(6,008)	8%
Depreciation and amortisation	(409)	(430)	5%
Income from operations	**2,132**	**1,712**	**-20%**
Other income/net interest	5	(4)	-180%
Income before provision for income taxes	**2,137**	**1,708**	**-20%**
Taxes	(857)	(509)	-41%
Net income	**1,280**	**1,199**	**-6%**

Source: OTCM, Edison Investment Research

OTCQX issuers and issuer service fees

Issuer services in Q113 generated 19% of our previous 2013e annual forecast revenue. OTCQX was very successful in attracting Canadian resource companies to the marketplace through 2011 and early-2012. Falling commodity prices in H212 and through 2013 to date means this has not continued, as the financial position of many mining and resource companies has weakened. This contributed to a greater number of non-renewals in January (13% against 5% a year ago) and slower growth in new companies signing on (see Exhibit 2 below). The slowdown in new customer acquisition has continued over the past 10 weeks, with new customers to OTCQX at c 40% of the level seen in the same period in 2012.

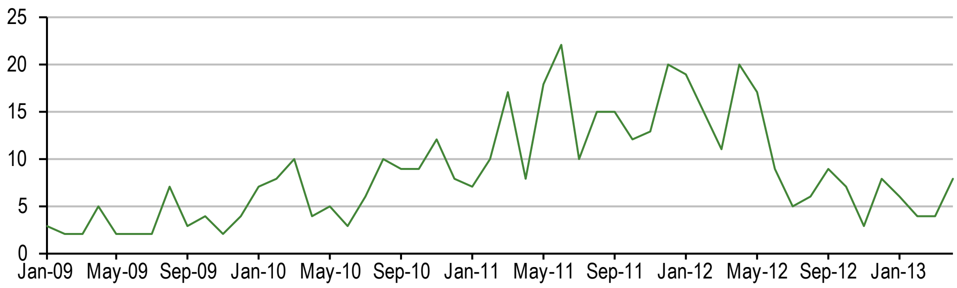
Additionally, declining values in mining interests saw a number fall below the net asset criteria of OTCQX, thereby disqualifying them from inclusion in the market place. This led to an additional reduction of companies between January and April.

The financial effects are significant. The Q113 revenue, although affected by high non-renewal rates, still had the benefit of growth seen in H112. As we progress through 2013, the comparators will become increasingly hard if the 2013 new customer acquisition continues to be well below 2012 levels. The 13% non-renewals will reduce annual issuer services fees by around $750k (c 8% issuer fees, 2% off group revenue) and on current run rates, admission fees will be c $300k less.

However, we are now forecasting stable revenue rather than a fall, to give credit for management action.

OTCM is aiming to address each aspect of volume story, namely by increasing the speed of customer acquisition, diversifying industrial concentrations away from mining/resources and slowing down the rate of non-renewal. We expect further details on specific proposals to emerge through 2013.

Exhibit 2: New companies joining OTCQX marketplace (monthly)



Source: OTCM announcements, Edison Investment Research

Investment

We note that OTCM has been investing heavily in its IT infrastructure and data centre capacity. The current system has been highly reliable – operational availability was 99.998% during 2012 and largely associated with connectivity with external networks – but management is looking to broaden the range of products it provides, further improving the quality of revenue. IT expenses increased 15% on Q112 to $914k in Q113. The investment has not only been in technology, with the headcount increasing 18% to 78. This investment had been well flagged and costs overall were a little below our annualised run rate, with the timing of some marketing and adverting initiatives not falling in Q113.

Management confidence in the business is also demonstrated by the 20% increase in dividend to 6c in the quarter. We had been expecting a 10% increase.

Trading services

The weakness in revenue Q113 on Q112 was in trading services, where continued pressure on the smaller broker-dealer community resulted in lower income from dealer licences, connection fees and subscriptions. We note that market conditions were worse through late-2012 and that Q113 revenue was modestly above the levels of both Q312 and Q412.

Valuation

Our Gordon's growth valuation model implies a value of $9.8 based on a sustainable ROE of 20% (well below 2013/2014e 30%+ levels), a cost of equity of 9% and growth of 5%.

Our cash flow approach (taking explicit forecasts for two years, 10 years on an assumed 5% growth, 9% discount rate and terminal value at 10x final cash flow) generates a value of $10.2. We believe OTCM is trading largely in line with the large exchanges on a forward P/E basis.

Financials

We have cut our forecast issuer services revenues from $11.8m and $14.2m to $10.0m and $11.0m in 2013 and 2014 respectively. We have also trimmed costs by $0.5m and $1m respectively. The weakness in new business flows has continued at a slightly faster pace than seen in H212 after the exceptional growth in 2011 and H112. We have left our annual tax rate at 40% noting the 30% reported in Q113 included R&D allowances brought forward including a benefit from 2012.

Exhibit 3: Key financials – profit and loss ($000s)

	2009	2010	2011	2012	2013e	2014e
Trading services	9,894	11,378	11,773	11,640	12,571	13,577
Market data licensing	10,911	11,858	13,111	13,555	14,911	16,402
Issuer services	3,227	4,803	8,067	9,831	10,000	11,000
Gross revenues	**24,032**	**28,039**	**32,951**	**35,026**	**37,482**	**40,978**
Re-distribution fees and rebates	(1,944)	(2,168)	(2,188)	(1,842)	(2,026)	(2,229)
Net revenue	**22,088**	**25,871**	**30,763**	**33,184**	**35,456**	**38,750**
Operating expenses (exc depreciation and amortisation)	(15,520)	(19,723)	(22,299)	(22,606)	(24,500)	(26,500)
Depreciation and amortisation	(835)	(1,017)	(1,358)	(1,622)	(1,800)	(2,000)
Income from operations	**5,733**	**5,131**	**7,106**	**8,956**	**9,156**	**10,250**
Other income/net interest	(89)	(69)	(115)	30	0	0
Income before provision for income taxes	**5,644**	**5,062**	**6,991**	**8,986**	**9,156**	**10,250**
Taxes	(2,138)	(2,127)	(2,139)	(3,509)	(3,662)	(4,100)
Net income	**3,506**	**2,935**	**4,852**	**5,477**	**5,493**	**6,150**
Diluted adjusted EPS ($)	0.33	0.28	0.45	0.51	0.50	0.56
Operating margin (inc from ops/net revenue)	26%	20%	23%	27%	26%	26%
Tax rate	-38%	-42%	-31%	-39%	-40%	-40%

Source: OTCM, Edison Investment Research

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Exhibit 4: Key financials – balance sheet ($000s)

	2009	2010	2011	2012	2013e	2014e
Current assets						
Cash and cash equivalents	**5,385**	**6,703**	**10,170**	**13,611**	**18,185**	**22,674**
Short-term instruments	0	0	1,297	0	0	0
Accounts receivables net of allowances	5,861	5,329	7,194	6,481	7,000	7,750
Pre-paid income taxes	215	582	307	345	450	500
Pre-paid expenses and other current assets	652	381	417	744	744	744
Deferred tax assets (net)	102	259	293	203	203	203
Total current assets	**12,215**	**13,254**	**19,678**	**21,384**	**26,582**	**31,871**
Property and equipment (net)	4,021	4,036	5,143	5,066	5,066	5,066
Goodwill	251	251	251	251	251	251
Intangibles	139	88	40	40	40	40
Security deposits	89	181	209	209	209	209
Deferred tax assets (net)	0	0	0	0	0	0
Total non-current assets	**4,500**	**4,556**	**5,643**	**5,566**	**5,566**	**5,566**
Total assets	**16,715**	**17,810**	**25,321**	**26,950**	**32,148**	**37,437**
Current liabilities						
Accounts payable	791	387	629	721	600	600
Current portion of bank loan	786	92	0	0	0	0
Accrued expenses and other	2,180	1,970	3,066	2,868	3,000	3,000
Dividend payable	336	414	419	0	500	650
Income tax payable	0	0	0	0	0	0
Income tax reserve	0	372	109	0	0	0
Deferred revenue	2,731	4,299	6,628	7,670	8,670	9,670
Total current liabilities	**6,823**	**7,534**	**10,851**	**11,259**	**12,770**	**13,920**
Bank loan	1,246	0	0	0	0	0
Deferred rent	757	816	926	786	675	575
Deferred tax liabilities net	176	200	475	113	113	113
Income tax reserve	0	0	197	277	277	277
Total non-current liabilities	**2,179**	**1,016**	**1,598**	**1,176**	**1,065**	**965**
Total liabilities	**9,002**	**8,550**	**12,449**	**12,435**	**13,835**	**14,885**
Net assets inc non-controlling interests	7,713	9,260	12,872	14,515	18,313	22,552
Year-end no of shares	8,408,942	10,480,945	10,615,433	10,830,885	11,030,885	11,230,885
Equity NAV per share ($)	**0.917**	**0.884**	**1.213**	**1.340**	**1.660**	**2.008**

Source: OTCM, Edison Investment Research

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