EDISON

OTC Markets Group

H1 results

Increasing recognition, 100% uptime

Financial services

OTC Markets Group's second-quarter results showed progress against a relatively subdued market background, underlining the benefits of its mainly subscription-based business model. Investment in the IT platform continues to pay off in the shape of 100% uptime. The achievement of Blue Sky recognition from five states is a promising early indicator of the group's ability to broaden its appeal to a wider range of corporate clients.

Year end	Revenue ($m)	PBT* ($m)	EPS* ($)	DPS** ($)	P/E (x)	Yield (%)
12/14	42.2	12.9	0.69	0.82	25.0	4.8
12/15	49.9	16.9	0.88	1.08	19.6	7.6
12/16e	50.7	16.6	0.86	1.16	20.1	6.7
12/17e	53.3	17.7	0.89	1.20	19.4	7.0

Note: *Fully diluted and calculated after restricted stock awards and excluding exceptional items and amortisation of acquired intangibles. **Including special declared dividends of $0.5 for 2014, $0.6 for 2015 and an estimated $0.6 for 2016 and 2017.

Second quarter results

OTC Markets Group (OTCM) reported second-quarter revenues 2% ahead and net income up 5% compared with the same period last year. By business line, OTC Link ATS revenues were down 9%, reflecting pricing changes made last year and reduced volumes, while market data was modestly up and corporate services ahead by nearly 10%, driven by a higher number of corporate clients compared with Q215. The quarterly dividend was maintained at $0.14 (the 31st consecutive quarterly dividend payment).

Outlook

Signals on the near-term outlook for capital markets activity could be seen as mixed, with uncertainty over the economic and political outlook in the US and Europe potentially acting as a brake on both IPOs and the appetite of companies to sign up to OTCM's services. However, market levels have been surprisingly buoyant and, looking further ahead, there is a significant opportunity for OTCM to achieve greater market share both in terms of corporate clients and the reach of its market data. US regulatory changes facilitating online/crowdsourcing could create a population of growing companies for whom OTCM's relatively low cost and less administratively onerous route to public trading would be particularly appealing. In addition, progress towards the eventual target of Blue Sky exemptions in all 50 US states and one district could progressively raise OTCM's profile and the range of companies that would consider using its services.

DCF suggests upside and yield is supportive

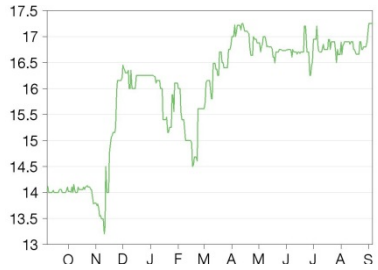
Relative to quoted financial information providers OTCM trades at a noticeable P/E discount and also trades on a more modest discount to the average for global exchanges. We have updated our central DCF valuation giving a value of $18.7 per share (vs $19.2). Excluding our estimated special dividend of $0.6 for this year the shares would yield 3.3%, while including it pushes the prospective yield to 6.8%.

6 September 2016

Price	**US$17.25**
Market cap	**US$193m**

Net cash ($m) at 30 June 2016	23.3
Shares in issue	11.2m
Free float	60%
Code	OTCM
Primary exchange	OTCQX
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	2.1	3.0	22.8
Rel (local)	2.5	(0.5)	10.1
52-week high/low	US$17.2		US$13.2

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 event

Q3 results	November 2016

Analysts

Andrew Mitchell	+44 (0)20 3681 2500
Martyn King	+44 (0)20 3077 5745

financials@edisongroup.com

Edison profile page

OTC Markets Group is a research client of Edison Investment Research Limited

A mission to provide informed, efficient markets

OTCM began to take its current form after a group of investors led by CEO, R Cromwell Coulson, acquired the National Quotation Bureau (NQB) in 1997. NQB published the 'Pink Sheets' in paper form, which aggregated broker-dealer quotes for securities traded off exchange. Under the new ownership, the company adopted new technology to enable greater efficiency and improved transparency, beginning the transformational move to a real-time electronic platform for broker dealers to price and trade equities. Launched in 2003, this system evolved into the current, SEC registered OTC Link Alternative Trading System (ATS).

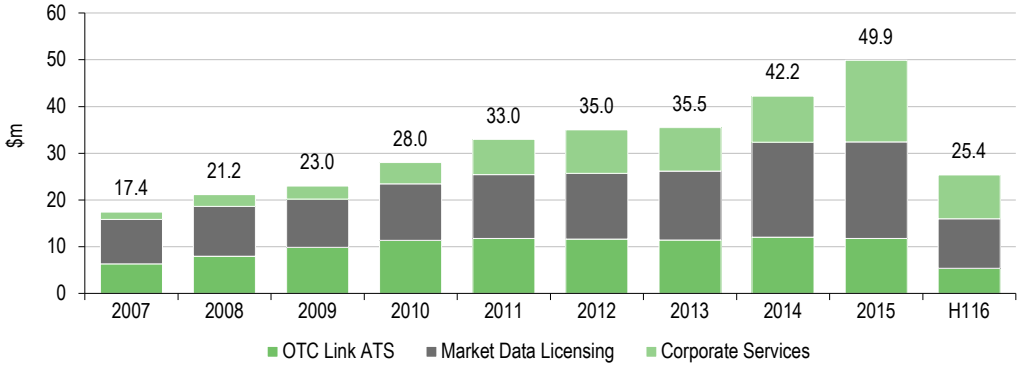
The OTCM ATS reported 112 active, broker dealer participants and carried quotes in nearly 10,000 securities at the end of Q216. To help investors properly price risk, companies are organised into three markets that are tiered based on the timeliness, quality and quantity of information they provide:

- **OTCQX Best Market**: for investor-focused companies that meet high financial standards, are current in their disclosure and have third-party advisers. Of the 383 OTCQX companies 63% are international and among the 143 US companies 76 are banks.
- **OTCQB Venture Market**: for developing companies meeting standards that promote price transparency and facilitate public disclosure. OTCM believes many companies listed on TSX Venture, LSE AIM and other non-US venture exchanges could be served by the OTCQB Venture market. At end Q2 there were 932 company clients in OTCQB.
- **Pink Open Market**: for all types of companies; the companies included are further organized based on the quantity and timeliness of disclosure (Current, Limited and No Information).

In addition to OTC Link ATS, which contributed 21% of revenue, OTCM has two other business lines: market data licensing (41% of revenue) and corporate services (35% of revenue). For access to OTCM Link ATS, broker dealers pay subscription fees, quote fees for Pink securities and messaging fees. Market data licencing provides access to real-time and historical pricing data, together with corporate financial information and compliance data. Market data is disseminated through over 50 distributors such as Bloomberg, Interactive Data Corporation, Thomson Reuters and Fidessa and via enterprise level licencing arrangements. Corporate services revenues are mainly generated from fixed application and annual charges to companies on the premium OTCQX and OTCQB markets. Pink companies may subscribe separately to disclosure, news and other services.

Revenues have grown at an annual compound rate of 14% between 2007 and 2015, with the most rapid growth seen in the Corporate services business segment (Exhibit 1).

Exhibit 1: Gross revenue evolution and analysis



Source: OTC Markets Group

Q216 results: Resilient

OTCM produced a resilient second-quarter performance against a slow market environment, broadly continuing the trends seen in the first quarter. Compared with the second quarter last year, tariff changes, continued consolidation among broker dealers and lower quote and message volumes resulted in lower revenues at OTC Link ATS. Market data income was stable and corporate services revenue was materially ahead, reflecting a higher average number of companies signed up to OTCQB than in the prior-year period. Key points from the second-quarter results include:

- Total revenues increased by 2% to $12.6m.
- Revenue by business line showed mixed trends with OTC Link ATS down 9%, market data licencing up 1% and corporate services up by nearly 10% (see below for more detail).
- Expenses increased by 2.5% within which compensation costs (63% of the total) increased 4%, in part reflecting additional headcount, while IT spending was up 20% following investment in OTCM's technology infrastructure both this year and last.
- The investment has helped maintain the improvement in the reliability of OTCM's core Link ATS systems with continued 100% trading-hours uptime maintained in the quarter, confirming the turnaround from difficulties experienced in earlier years.
- Income from operations was just above the prior-year period with the operating margin slightly down at 34% versus 35% (see Exhibit 2 for comparative P&L numbers).
- The quarterly dividend is maintained at $0.14.
- Looking ahead, the company sees the recognition given to OTCQX and OTCQB by five states as electronic securities manuals under their Blue Sky manual exemptions as the most significant development in the period. Further successes on this front would have the potential to increase significantly the number of US and international companies that would consider using the OTCM platform.

Exhibit 2: Q216 results summary

($000 unless stated)	Q215	Q116	Q216	% change vs Q215	% change vs Q116
OTC Link ATS	2,931	2,754	2,658	(9.3)	(3.5)
Market data licensing	5,169	5,325	5,237	1.3	(1.7)
Corporate services	4,330	4,672	4,744	9.6	1.5
Gross revenues	**12,430**	**12,751**	**12,639**	**1.7**	**(0.9)**
Re-distribution fees and rebates	(600)	(593)	(584)	(2.7)	(1.5)
Net revenue	**11,830**	**12,158**	**12,055**	**1.9**	**(0.8)**
Operating expenses	(7,741)	(8,361)	(7,936)	2.5	(5.1)
Income from operations	**4,089**	**3,797**	**4,119**	**0.7**	**8.5**
Operating margin %	35	31	34		
Other income / net interest	7	(8)	4	0.0	0.0
Income before provision for income taxes	4,096	3,789	4,123	0.7	8.8
Taxes	(1,704)	(1,474)	(1,608)	(5.6)	9.1
Net income	2,392	2,315	2,515	5.1	8.6
Diluted EPS $	**0.20**	**0.20**	**0.21**	**5.0**	**5.0**

Source: OTC Markets Group

In Exhibit 3 we have shown further analysis of OTC Link ATS and Corporate services revenues drawn from the management commentary (the numbers should be treated as indicative as they are mainly inferred from percentage changes and by deduction). Looking at the OTC Link ATS analysis, we can see the impact of fee changes made in July last year when quote fees were eliminated from the two premium markets. Even with an increase in fees on Pink, overall quote fees were down by nearly a third. Messaging fees were increased at the same time, resulting in a sharp increase in revenue in this area but, with continuing consolidation among broker dealers resulting in reduced participant subscriptions, the overall segment revenue was down 9%.

On Corporate services, as noted earlier, the higher average number of OTCQB companies during the period contributed to 18% growth in revenues, while OTCQX revenues were broadly flat despite a slightly lower average number of client companies. New companies joining OTCQX have been paying annual fees of $20,000 since the start of the year while existing clients will remain on the previous tariff of $15,000 until the beginning of 2017.

Exhibit 3: Revenue analysis for OTC Link ATS and Corporate Services activities

($m unless stated)	Q215	Q116	Q216	% change vs Q215	% change vs Q116
OTC Link ATS					
Quote position	0.83	0.60	0.57	(32.0)	(4.6)
Trade messages	0.60	0.80	0.77	29.0	(3.6)
Market participant subscriptions	1.24	1.33	1.13	(9.0)	(14.9)
Other	0.26	0.03	0.19		
Total	**2.93**	**2.75**	**2.66**	**(9.3)**	**(3.5)**
Corporate services					
OTCQB	1.93	2.30	2.28	18.0	(0.8)
OTCQX	1.66	1.47	1.69	1.8	14.4
Disclosure and news service	0.74	0.90	0.78	5.0	(13.5)
Total	**4.33**	**4.67**	**4.74**	**9.6**	**1.5**

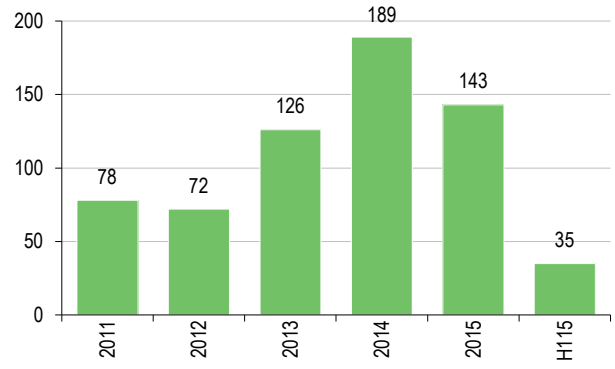
Source: OTC Markets Group, Edison Investment Research

Staying with Corporate services, the company reports that the number of verified companies on OTCQB had fallen to 877 at the end of June, compared with 929 at the end of the first quarter and 955 at end June 2015. This reduction reflected a higher rate of compliance-related downgrades and non-renewals and OTCM expects this venture market to continue to see a higher rate of 'churn' given the relatively early-stage profile of these clients. For OTCQX, the number of companies has fallen from 424 at the year-end to 383 at end June, with a sluggish market background for new sales meaning they have failed to keep pace with the normal attrition of the client list. In the next section we review evidence of recent market trends and try to gain a sense of whether the environment is likely to become more favourable.

Current trading environment and outlook

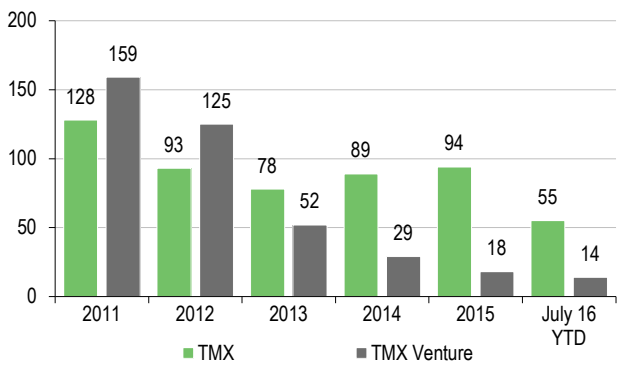
As an indicator of the general environment in equity capital markets, we have collated data for the number of IPOs on Nasdaq, TMX, TMX Venture and AIM. Looking first at Nasdaq and the TMX exchanges (Exhibits 4 and 5) we can see that the Nasdaq count has been on a downtrend since 2014 while the pattern for the TMX markets, with their significant commodity exposure, is different with an earlier decline but a stronger pro rata number of IPOs year-to-date.

Exhibit 4: Nasdaq – number of IPOs



Source: Nasdaq

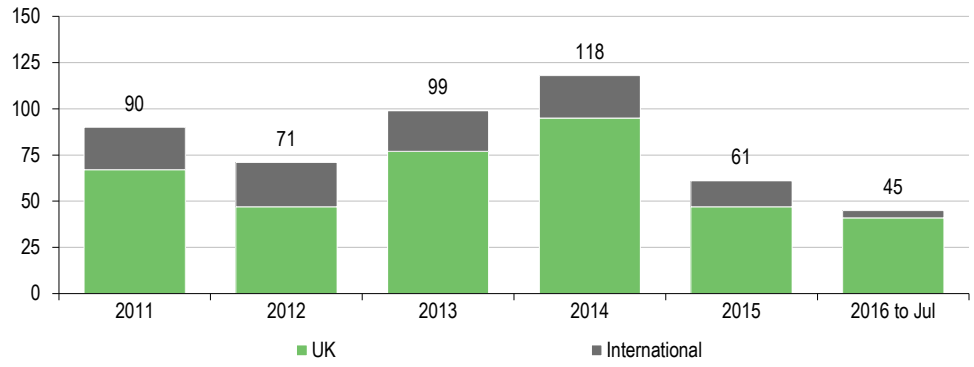
Exhibit 5: TMX and TMX Venture – number of IPOs



Source: TMX

In the UK, the AIM market (Exhibit 6) experienced a virtual halving in the number of IPOs last year but, despite the uncertainties surrounding the EU referendum, the run rate in 2016 to end July was actually ahead of 2015 (45 versus 37).

Exhibit 6: AIM – number of admissions

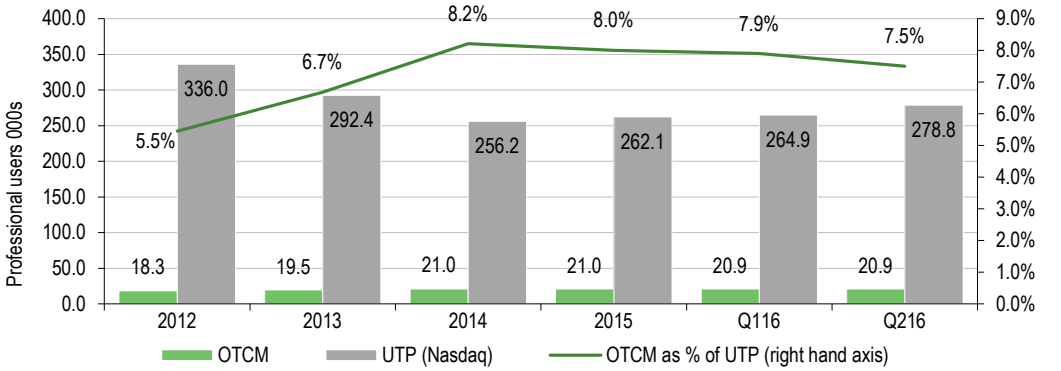


Source: AIM

While the global macroeconomic backdrop has appeared uncertain and GDP growth estimates have generally been trimmed, equity markets have been surprisingly buoyant. In the year to date each of the indices for the markets discussed are up, to a greater or lesser extent (S&P/TSX Composite +12%, S&P/TSX Venture +51%, Nasdaq Composite +4% and FTSE AIM All-Share +7% at 1 September). Subject to a marked weakening in economic conditions, we would expect this resilience to be broadly supportive for the level of IPO activity prospectively and by extension for the potential number of new clients for OTCM's premium markets. OTCM itself has indicated it will be sharpening its focus on retaining OTCQB companies following the substantial reduction in numbers that followed the introduction of new eligibility standards in 2014/15; it is also looking to expand the sales pipeline for both OTCQX and OTCQB.

The trend for contraction in and consolidation among broker-dealers has contributed to the decline in the number of active participants in OTC Link ATS (from 133 at the end of 2012 to 112 at the end of the second quarter). This might also be seen as putting some pressure on the number of professional market data users but over the same period this has risen (Exhibit 7), although there has been a flattening since 2014. However, as OTCM points out, its penetration of the potential market is still relatively small, so even if the overall market shrinks there should be scope to increase penetration. In Exhibit 7 we have shown professional users of UTP (Nasdaq) market data and OTCM's users as a percentage of that number. This suggests significant upside, signalling the opportunity for a virtuous circle if OTCM is able to reinforce the reputation of its premium markets by securing further Blue-Sky manual exemptions, maintaining the record of platform uptime and enhancing transparency through the availability of corporate data and further third party research (Morningstar currently provides this).

Exhibit 7: OTCM and UTP (Nasdaq) professional users



Source: OTCM, UTP Plan, Edison Investment Research

Beyond the Blue-Sky exemptions noted above, there were no significant new regulatory developments affecting the business in the last quarter. The medium- to longer-term positive theme related to the Jumpstart Our Business Startups (JOBS) Act (including Regulation A+ and Regulation Crowdfunding) remains in place. So far one company has made a successful crowdfunding equity offering under Regulation A+ and began trading on OTCQX in Q116 (Elio Motors). Developing the use of online funding or crowdfunding could generate a rising population of companies that may be attracted to the OTCM offering, as it seeks to facilitate public trading of shares with less financial and administrative burden than a listing on a national securities exchange. OTCM aims to charge less than half the price of a Nasdaq listing for OTCQX and less than a quarter of Nasdaq's lowest price for OTCQB.

Competitive pressures and regulatory risks remain factors to consider. Successful companies are likely to continue to 'graduate' to a national securities exchange from the OTC platform (60 did in 2015) but this is also a badge of success for OTCM. National securities exchanges (or new ventures) could seek to create trading venues to offer competing services for developing US companies: even if they did not gain traction, there could be negative pricing implications.

New regulations could impose higher costs (as was the case with Regulation Systems Compliance and Integrity) or affect revenues. In 2009 FINRA filed a proposed Quotation Consolidation Facility (QCF) with the SEC, which OTCM indicates could impact market data income by removing c 17% of gross revenues if it is approved. There have been no reports of new developments relating to this proposal in recent years, but OTC indicates it has submitted multiple letters in opposition.

In summary, while the economic backdrop is uncertain, markets have proven resilient and there are some signs of increased IPO activity that give near-term encouragement for OTCM. On a longer-term view, regulatory and competitive risks cannot be ignored, but OTCM should be well positioned to benefit by recruiting clients among companies employing disruptive online capital raising. Its increased focus on reliability through IT investment, and success in achieving additional state Blue-Sky recognition combined with the higher quality thresholds established for its premium markets should also widen the pool of potential corporate clients.

Financials

Following the second-quarter results we have modestly reduced our estimates as shown in Exhibit 8, primarily reflecting a slightly lower starting point, particularly within the OTC Link ATS business line where we have also allowed for further consolidation among active participants in the forecast years. Positive factors for revenue include the fact that from the end of this year a significant number of OTCQB companies will move from a promotional subscription fee of $7,500

per year to $10,000. At the end of the second quarter, 42% of companies were on the promotional rate. Similarly, for OTCQX, companies that were clients last year will move to the new fee level of $20,000 per year versus $15,000 at the beginning of 2017.

Exhibit 8: Earnings revisions

	Gross revenue ($m)			PBT ($m)			EPS ($)			Dividend ($)		
	Old	New	% change	Old	New	% change	Old	New	% change	Old	New	% change
2016e	52.3	50.7	-3%	17.1	16.6	-2%	0.89	0.86	-4%	1.16	1.16	0%
2017e	54.4	53.3	-2%	17.8	17.7	0%	0.91	0.89	-3%	1.20	1.20	0%

Source: Edison Investment Research

At the end of the second quarter, cash on the balance sheet was $23.3m and, on our estimates, is likely to be above $20m for end 2016 and 2017.

Valuation

As an initial step in considering the valuation, we place OTCM in the context of two substantial US financial information providers, MSCI and Markit, together with average P/Es for global exchanges and the S&P 500 index. Given the differences in size of businesses and the business models, direct comparisons are difficult but the predominantly subscription-based revenues at OTCM mean that the information providers are relevant comparators while the exchanges include competitors and generally generate significant revenue from market data. On this comparison OTCM trades on multiples above the S&P 500 but on modestly lower P/Es than the exchanges and is noticeably below the average for the information suppliers. Positive news on further state Blue Sky recognition and evidence of success in building the corporate sales pipeline are among the potential catalysts for a rerating.

Exhibit 9: OTCM comparative multiples

	Estimated P/E ratios (x)	
	FY16	FY17
MSCI	30.8	25.9
Markit	21.0	18.0
Average information providers	**24.8**	**21.0**
Average global exchanges	**21.7**	**19.5**
S&P 500	18.4	16.3
OTCM	**19.9**	**19.2**

Source: Bloomberg, Edison Investment Research. Note: Prices as at 1 September 2016.

We have also refreshed our discounted cash flow model for OTCM and in Exhibit 10 show a sensitivity table for values at different discount rates and intermediate-term growth rates. Our unchanged central assumptions are a discount rate of 9%, cash flow growth of 3% and a terminal value multiple of 10x. The resulting indicative value is $18.7 compared with our previous central value of $19.2, reflecting the modest reductions in our estimates noted above.

Exhibit 10: Discounted cash flow valuation sensitivity ($ per share)

Discount rate (right) 2018-26e growth	7%	8%	9%	10%	11%
2%	20.0	18.8	17.8	16.8	15.9
3%	21.1	19.8	**18.7**	17.6	16.7
4%	22.2	20.9	19.7	18.5	17.5
5%	23.5	22.0	20.7	19.5	18.4

Source: Edison Investment Research

Exhibit 11: Financial summary

$ 000s	2014	2015	2016e	2017e
Year end 31 December				
PROFIT & LOSS				
OTC Link ATS	12,019	11,796	10,612	10,800
Market Data Licensing	20,334	20,610	21,042	21,500
Corporate Services	9,862	17,503	19,066	20,973
Revenue	42,215	49,909	50,720	53,273
Re-distribution fees and rebates	(2,388)	(2,379)	(2,357)	(2,500)
Net revenue	39,827	47,530	48,363	50,773
Operating expenses	(25,382)	(28,972)	(30,070)	(31,273)
EBITDA	14,445	18,558	18,293	19,500
Depreciation	(1,543)	(1,692)	(1,647)	(1,750)
Operating Profit	12,902	16,866	16,646	17,750
Net interest/other income	9	27	(4)	0
Profit Before Tax (norm)	12,911	16,893	16,642	17,750
Tax	(5,021)	(6,635)	(6,487)	(6,922)
Profit After Tax (FRS 3)	7,890	10,258	10,155	10,827
Profit After Tax (norm)	7,638	9,971	9,895	10,567
Fully diluted av. No. of shares (m)	11.1	11.3	11.5	11.9
EPS - normalised fully diluted (c)	68.58	88.32	85.93	88.95
Fully diluted EPS - FRS 3 ($)	0.71	0.91	0.88	0.93
Dividend per share (c)	82.00	108.00	116.00	120.00
EBITDA Margin (%)	36	39	38	38
Operating profit margin (%)	32	35	34	35
BALANCE SHEET				
Fixed Assets				
Intangible Assets	291	291	291	291
Tangible Assets	4,357	3,507	2,233	1,483
Investments	210	210	210	210
Current Assets				
Debtors	5,674	6,082	5,104	6,500
Cash & cash investments	20,272	23,925	20,103	20,909
Current Liabilities				
Creditors	(4,450)	(4,971)	(3,236)	(2,512)
Long Term Liabilities				
Deferred rent	(391)	(139)	(303)	(240)
Other long term liabilities	(954)	(867)	(1,132)	(991)
Net Assets	18,251	17,547	15,914	14,951
NAV per share ($)	1.62	1.55	1.41	1.32
CASH FLOW				
Operating Cash Flow	16,985	22,400	16,837	20,652
Net Interest	9	27	(4)	0
Tax	(4,492)	(5,320)	(6,803)	(5,327)
Capex	(1,582)	(940)	(373)	(1,000)
Financing / investments	(475)	(420)	(411)	0
Dividends	(9,109)	(12,094)	(13,068)	(13,518)
Net Cash Flow	1,336	3,653	(3,822)	806
Opening net (debt)/cash	18,936	20,272	23,925	20,103
Closing net (debt)/cash	20,272	23,925	20,103	20,909

Source: OTCM, Edison Investment Research

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Frankfurt +49 (0)69 78 8076 960
Schumannstrasse 34b
60325 Frankfurt
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
245 Park Avenue, 39th Floor
10167, New York
US

Sydney +61 (0)2 9258 1161
Level 25, Aurora Place
88 Phillip St, Sydney
NSW 2000, Australia

Wellington +64 (0)48 948 555
Level 15, 171 Featherston St
Wellington 6011
New Zealand