EDISON

OTC Markets Group

Q114 results

Enhancing its franchise

Financial services

OTC Markets Group (OTCQX: OTCM) provides regulated marketplaces offering a cost-effective solution for targeting US investors. In Q114, Market Data Licensing revenues grew nearly 40% on Q113 as OTCM increased fees for the first time since 2009. Critically, it also significantly grew its subscriber base. With recent strengthening in OTCQB requirements, and the development of OTCQX Banks, OTCM now has options fitting companies in all stages of their equity-market development. Corporate services fees should grow in 2015 with the new premium services now on offer.

Year end	Revenue ($m)	PBT* ($m)	EPS* (c)	DPS (c)	P/E (x)	Yield (%)
12/12	33.2	9.0	50.5	20.0	17.1	2.3
12/13	33.6	8.3	50.8	24.0	17.0	2.8
12/14e	38.7	11.9	64.8	27.6	13.3	3.2
12/15e	46.3	17.9	96.4	31.7	9.0	3.7

Note: *PBT and EPS are normalised, excluding intangible amortisation, exceptional items and share-based payments.

Q114 Market Data Licensing (MDL) revenue uplift

The key feature in Q114 was the 39% increase in MDL revenue. Around two fifths of the growth came from an increase in the subscriber base. OTCM also introduced new pricing effective from 1 January 2014 with minimal client losses. Management believes the fee structure has been brought only in to line with peers. Trading services revenue saw a modest increase, with greater quote activity somewhat offset by lower subscriptions (fewer active dealer users). In corporate services the reduction in OTCQX clients has continued, especially in the resource sector. Cost control was good (up 2% on Q113).

2014 franchise enhancements

OTCM has made a number of changes that should improve the differentiation of its marketplaces. The OTCQB incremental requirements should enhance investor confidence in securities traded on this marketplace. The changes are designed to make OTCQB a better venture stage, premium marketplace with fee based services. OTCQB will also be open to international issuers. The disclosure requirements take effect 120 days after the issuers' financial year ends and we expect most customers to make the decision to stay on the new OTCQB in Q115 following most companies December 2014 year end . In addition, a new premium service targeted at regional banks (OTCQX Banks) has also been launched.

Valuation: Upside from new revenue generation

Now that it is clear there will be no material client attrition with the MDL re-pricing, we have upgraded our estimates to reflect the increased fees reported in Q114. In 2015 we have also assumed an incremental $5m in corporate issuer fees. The average of our valuation approaches is $15.5 per share, giving a comfortable upside to the current price. Both our cash generation and Gordon's growth model valuations have increased following the revenue upgrades.

19 May 2014

Price	**US$8.65**
Market cap	**US$95m**

Net cash ($m) at March 2014	17.4
Shares in issue (exc treasury)	11.0m
Free float	60%
Code	OTCM
Primary exchange	OTCQX
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	0.0	12.3	2.4
Rel (local)	(0.8)	10.0	(10.0)
52-week high/low		US$8.8	US$7.6

Business description

OTC Markets Group (OTCM) operates the OTCQX, OTCQB and OTC Pink financial marketplaces for 10,000 US and global securities. Its trading system OTC Link ATS is operated by OTC Link LLC, a member of FINRA/SIPC and SEC regulated ATS.

Next event

H114 results	Early August 2014

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Q114 results

Market data licensing ($5.0m, 50% of Q114 revenue, FY13 42%)

OTCM's market data distribution network includes all the major financial data distributors and online brokerage firms. MDL fees rose by 39% ($1.4m) of which c $0.8m was due to re-pricing and $0.6m from the increased subscriber base. In Q114, the major sources of revenue were:

- User license subscriptions ($3.3m) increased by $0.9m, 38%.
- Enterprise licence subscriptions ($0.7m), which include broker-dealer enterprise licences, internal system licences, derived data licences and real-time delayed licences, increased by $0.25m, 52%.
- End-of-day pricing services ($0.6m) increased by $0.1m, 29%.

For the first time since 2009, price increases were put through, effective from 1 January 2014, with management saying it was bringing their pricing in line with peers. We waited for Q114 results before fully including the benefit from this re-pricing in case there had been any client attrition. But client losses have been minimal and customer behaviour has not changed. The scale of the re-pricing for selected product lines is given in Exhibit 1.

Exhibit 1: Examples of re-pricing effective 1 January ($ per month)

	Old	New	Change (%)
Professional subscriber account level 1	24	30	25
Professional subscriber account level 2	30	75	150
OTC Markets Level 1+ Broker-Dealer Enterprise Licence	9000	10000	11
OTC Markets Level 2+ Broker-Dealer Enterprise Licence	18000	20000	11
OTC Markets Level 1+ Internal Systems/Applications Enterprise Licence	500	1000	100
OTC Markets Level 2+ Internal Systems/Applications Enterprise Licence	1000	2000	100
OTC Markets Level 2+ Internal Derived Data Licence	500	1000	100
OTC Markets Level 2+ External Derived Data Licence	1000	2000	100

Source: OTC Markets, Edison Investment Research

It is important to note that re-pricing accounted for just 60% of the increased revenue. As noted in previous reports, OTCM has been actively expanding its distribution of market data and its subscriber base, evidenced by a 9% expansion in the number of professional user licences and an increase in enterprise licences during Q114. This growth has been consistent over the past three years and we expect it continue over the forecast period. Major new agreements include Seeking Alpha, MSN Money and tradeMonster (all signed in H213).

OTC Link ATS trading services ($2.9m, 29% of Q114 revenue, FY13: 32%)

In Q114, trading services generated $2.9m of revenue – an increase of $52k, 2% – and the major sources of revenue were:

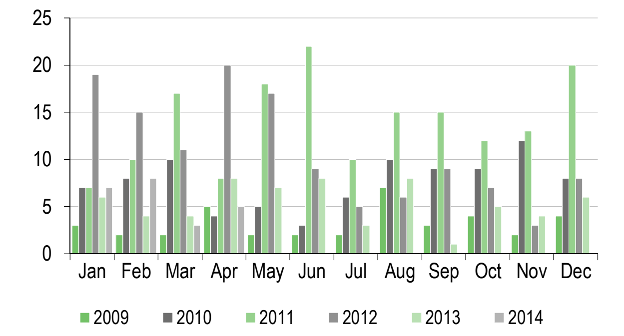
- Income from quote positions ($0.9m) – down $77k, 8% driven by the decline in numbers of broker dealers and OTC dealer users.
- OTC dealer licences, FIX connection fees and OTC Link subscriptions ($0.9m) down $43k, 5%, driven by the decline in numbers of broker dealers and OTC dealer users.
- Trade message revenue ($0.7m) up by $65k, 10% driven by an increase in the number of unique trade messages per market maker.
- QAP one statement fees ($0.2m) up by $131k, 114% driven by the increased number of shares traded.

The key message is that while overall trading volumes have increased, improving per subscriber usage based income, this has been largely offset as smaller, manual-trading brokers have been squeezed out of the market reducing the number of trader licence subscriptions.

Corporate services ($2.1m, 21% of Q114 revenues, FY13: 26%)

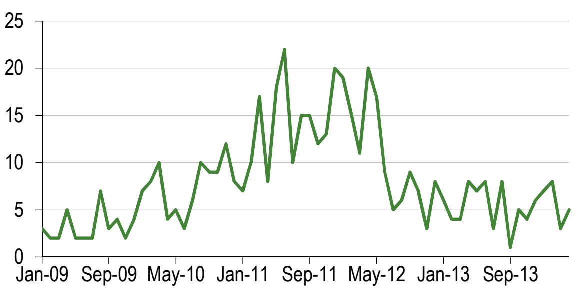
Q114 saw a continuation of revenue under pressure as weakness in the resource sector reduced the number of companies using OTCM services and overall revenue fell by $98k, 4%. The renewal rate in January 2014 was 83% (2013: 87%, 2012: 95%) and, as can be seen in the exhibits below, the gross number of new companies joining the OTCQX marketplace has also remained well below 2011/12 levels. Management action has been taken (see business update below) and we note an increase in premium service subscription revenue of $43k, or 5%, primarily related to improved retention rates in OTC Disclosure & News Service subscriptions.

Exhibit 2: New customers by month (OTCQX)



Source: OTC Markets, Edison Investment Research

Exhibit 3: Monthly progression new OTCQX customers



Source: OTC Markets, Edison Investment Research

Exhibit 4: Summary of companies listed by marketplace

Number of securities	Dec 2009	Dec 2010	Dec 2011	Dec 2012	Dec 2013	6 May 2014
OTCQX US	17	21	29	44	38	35***
OTCQX Int	61	138	285	356	332	304***
OTCQX total	**78**	**159**	**314**	**400**	**370**	**339*** **
OTCQB**	3,321	3,851	3,625	3,401	3,143	2,783
OTC Pink (total)	5,879	5,954	6,227	6,173	6,498	6,803
Total	9,278	9,964	10,166	9,974	10,011	9,925

Source: OTCM (www.otcmarkets.com/research/companyDirectory), Edison Investment Research. Note: *Of the OTC Pink number on 6 May, 3,533 were current info, 543 limited info and no info basis 2,727. **Actual launch April 2010. ***A fall in Q1 is not unusual given the January renewal process.

The various provisions within the Jumpstart Our Business Startups (JOBS) Act should make additional securities available for secondary trading on OTCM's marketplaces, but management is not able to determine any financial benefit at this stage. The implementation of the SEC proposed Regulation A+ (on which OTCM submitted a comment letter on 24 March 2014) will be an important point in this process.

Business update

OTCQB

OTCM introduced new standards for the OTCQB marketplace, effective on 1 May 2014. The standards are designed to raise the credibility of the marketplace with investors with more stringent requirements on issuers. It will move from a purely domestic, non-fee business into a premium one, charging fees and requiring traded companies to provide additional information to investors. The new OTCQB marketplace standards include minimum bid price standards that will migrate subpenny securities to the OTC Pink marketplace (226 securities were unable to meet the minimum bid price of $0.01 per share as of close of business on at least one of the previous 30 calendar days and so were downgraded on 1 May 2014). Additionally, companies subject to bankruptcy will no longer be able to trade their securities on OTCQB (13 securities downgraded on 1 May for this reason). Corporate managements will also need to certify that certain disclosures are correct. The new OTCQB standards must be met by120 days after the companies' fiscal year ends, and as most OTCQB companies have fiscal years that end on 31 December, we expect the majority of the revenue impact in 2015.

In addition to its current base of SEC-reporting companies and banks, OTCQB is now open to international venture-stage companies. Management estimates that three quarters of venture-stage companies listed on TSX Venture, LSE AIM and other non-US venture exchanges do not meet OTCQX's standards, and so opening OTCQB to them materially widens the potential issuer base.

The financial effects could be material. For new customers, the tariff will be a joining fee of $2,500 with an annual fee of $10,000. Existing OTCQB customers have been offered a discounted rate of $7,500 for the first two years and a waiver of the admission fee. If all the current OTCQB customers converted, this would generate annual income of c $21m against a current level of c $4m paid by all non-OTCQX issuers for corporate services. The conversion rate of existing customers to the new premium marketplace will be key to revenue uplift. We note:

- OTCQB corporates most likely to convert will be those willing to make investments in investor relations and probably have a higher propensity to take existing OTCM services than non-converters.
- OTCQB corporates could have upgraded to OTCQX if they had been willing to commit to the expense and time investments required, and given investor relations the strategic priority. The new OTCQB will be less time consuming and costly than OTCQX, but will still incur some cost for the issuers who will need to decide whether to increase their investor relations budgets.
- As noted above, OTCQB will require documentary compliance within 120 days of the issuers' financial year ends. As there are some companies with non-December year ends, through 2014 there should be early indications of the customer appetite for the new services.
- Before the majority of customers are affected post their December 2014 year ends, OTCM will be providing a comprehensive education programme to explain to corporates the advantages of the new standards and charges. We believe the conversion rate should be materially improved given the extended period before clients need to make the decision to convert.
- There remain limited alternative providers. FINRA's OTC Bulletin Board now has only modest trading, and it is unlikely the other providers (eg Nasdaq OMX's aborted BX Venture Market) will launch purely because of the revenue OTCM may generate. We also note that by improving the quality of the OTCQB, regulators are likely to be supportive.

We will review our estimates in light of how many companies convert through 2014, but have initially assumed conservatively that a third of OTCQB customers will migrate to the new service.

The company has given a presentation on its OTCQB changes.

OTCQX Banks

On 7 March 2014 OTCM announced the creation of a new marketplace for community and regional banks. Scheduled to launch on 21 May, OTCQX Banks' key features will include:

- Enhanced visibility with investors, depositors and the community, leveraging the perceived brand value of OTCQX.

- Transparent disclosure with less complexity – banks can leverage their existing financial reports and regulatory filings with OTCM ensuring financials are promptly distributed, readily available and easily researchable.
- Dedicated capital market support – banks can now appoint a principal 'corporate broker' as their OTCQX advisor, providing access to institutional investors, trading expertise, wealth management and investment banking services.
- Peer benchmarking – OTCQX Banks will also serve as a baseline for a new community bank index to provide a more accurate benchmark for the performance of small- and mid-sized banks across the nation.

Over 600 community and regional banks already trade on OTCQB marketplace, and we expect these to be initially targeted to earn the incremental fees from the increased functionality of OTCQX Banks. It may also be expected that the development of closer relationships with corporate brokers may be a source of introduction for new business in due course.

Valuation

On our estimates, OTCM is trading on a 2015e P/E of 9x. There are no peers on which to value OTCM. Our Gordon's growth valuation model implies a value of $14.13 (up from $11) based off a sustainable ROE of 20% (c 10% below the 2014/15e level), a cost of equity of 9%, growth of 5% and a premium of 25% for near-term outperformance (especially in ROE) against these long-term assumptions. These parameters are unchanged and the valuation uplift is due to the higher retained equity. Our cash flow approach (taking explicit forecasts for two years, 10 years on an assumed 5% growth, a 9% discount rate and terminal value at 10x final cash flow) generates a value of $16.8. This valuation benefits from the material uplift in 2015 cashflow driven by the incremental corporate services revenue.

Exhibit 5: Gordon's growth valuation and sensitivity

	Base	1% ROE	1% g	1% COE
ROE	20.0%	21.0%	20.0%	20.0%
Growth	5.0%	5.0%	6.0%	5.0%
COE	9.0%	9.0%	9.0%	10.0%
P/B	**3.8**	**4.0**	**4.7**	**3.0**
2015e NAV	3.02	3.02	3.02	3.02
Implied LT value	**11.31**	**12.06**	**14.07**	**9.05**
Near term premium	25%	25%	25%	25%
Implied fair value	**14.13**	**15.08**	**17.59**	**11.31**
Difference		0.94	3.45	(2.83)

Source: Edison Investment Research. Note: Number of shares includes treasury.

Financials

We have updated our forecasts for the incremental revenue generated from the MDL re-pricing. Customer behaviour has proved price insensitive and there have been no identifiable cancellations or downgrading of contracts associated with the higher prices. Accordingly, we have raised our 2014 MDL revenue forecast from $16.2m to $20.3m, most of which falls straight to the bottom line. We have trimmed the growth rate in trading services from 7% to 2% reflecting the continued attrition in OTC dealer users. Given the 4% decline in Q1 corporate service revenue we have trimmed our growth to zero from 2% in 2014. The new premium OTCQB platform together with OTCQX Banks means there is considerable uncertainty over this income in 2015. We have conservatively added $5m, assuming around a third of existing OTCQB users convert to become paying ones and that they already account for a significant part of non-OTCQX revenue (on 6th May there were 2,783 OTCQB securities and 3,533 OTC Pink securities with current information). This should prove conservative and we will update each quarter as we have more evidence on the conversion rate. We have left our cost assumptions unchanged. We have increased the dividend growth rate to 15% for 2014/15.

Exhibit 6: Changes to estimates

	Revenue ($m)			PBT ($m)			EPS (c)			Dividend (c)		
	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)
2014e	38.0	38.7	2	9.1	11.9	30	47.5	64.8	36	26.0	27.6	6
2015e	40.9	46.3	13	10.3	17.9	74	53.3	96.4	81	28.6	31.7	11

Source: OTC Markets, Edison Investment Research

Exhibit 7: Financial summary

$000s	2011	2012	2013	2014e	2015e
Year end 31 December					
PROFIT & LOSS					
Trading Services	11,773	11,640	11,437	11,666	12,482
Market data licensing	13,680	14,081	14,741	20,269	22,296
Corporate services	7,498	9,305	9,331	9,331	14,331
Re-distribution fees and rebates	(1,944)	(2,168)	(2,188)	(1,842)	(1,869)
Revenue	30,763	33,184	33,640	38,696	46,282
Cost of Sales	(22,299)	(22,606)	(23,700)	(25,000)	(26,500)
Gross Profit	8,464	10,578	9,940	13,696	19,782
Operating Profit (before GW and except.)	8,464	10,578	9,940	13,696	19,782
Intangible Amortisation & depreciation	(1,358)	(1,622)	(1,642)	(1,800)	(1,900)
Operating Profit	7,106	8,956	8,298	11,896	17,882
Net Interest	(115)	30	0	0	0
Profit Before Tax (norm)	6,991	8,986	8,298	11,896	17,882
Profit Before Tax (FRS 3)	6,991	8,986	8,298	11,896	17,882
Tax	(2,139)	(3,509)	(2,667)	(4,639)	(6,974)
Profit After Tax (norm)	4,791	5,361	5,466	7,091	10,743
Profit After Tax (FRS 3)	4,852	5,477	5,631	7,256	10,908
Average Number of Shares Outstanding (m)	10.47	10.54	10.68	10.89	11.09
EPS - normalised ($)	0.45	0.51	0.51	0.65	0.96
EPS - FRS 3 ($)	0.46	0.51	0.51	0.65	0.97
Dividend per share ($)	0.16	0.20	0.24	0.28	0.32
Gross Margin (%)	28%	32%	30%	35%	43%
EBITDA Margin (%)	28%	32%	30%	35%	43%
Operating Margin (before GW and except.) (%)	28%	32%	30%	35%	43%
BALANCE SHEET					
Fixed Assets					
Intangible Assets	291	291	291	291	291
Tangible Assets	5,143	5,066	4,184	3,542	2,900
Investments	209	209	210	210	210
Current Assets					
Debtors	7,194	6,481	4,980	7,750	8,500
Cash & cash investments	10,170	13,611	18,936	23,071	32,324
Current Liabilities					
Creditors	3,695	3,589	3,909	4,000	4,000
Long Term Liabilities					
Long term borrowings	926	786	608	575	575
Other long term liabilities	1,598	1,176	974	941	941
Net Assets	12,872	14,515	18,704	24,466	33,827
NAV ($ per share)	1.21	1.34	1.70	2.20	3.02
CASH FLOW					
Operating Cash Flow (pre-tax)	11,086	12,175	10,662	11,635	19,732
Net Interest	(115)	30	0	0	0
Tax	(1,871)	(3,498)	(2,334)	(4,660)	(6,974)
Capex	(2,426)	(1,346)	(471)	(1,000)	(1,000)
Financing / investments	(1,536)	1,301	79	1,218	1,073
Dividends	(1,671)	(5,221)	(2,611)	(3,057)	(3,579)
Net Cash Flow	3,467	3,441	5,325	4,135	9,253
Opening net debt/(cash)	6,703	10,170	13,611	18,936	23,071
Closing net debt/(cash)	10,170	13,611	18,936	23,071	32,324

Source: OTC Markets accounts, Edison Investment Research

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