

OTC Markets Group

Q214 results

Record quarterly revenue

OTC Markets Group (OTCQX: OTCM) provides regulated marketplaces offering a cost-effective solution for targeting US investors. Q214 gross revenues rose 15% compared with Q213, driven by a 41% increase in Market Data Licensing revenue from re-pricing and an increase in subscribers. This led to a 41% increase in operating profits and a 13% y-o-y increase in net income. More initiatives should produce revenue growth in 2015. The Q2 dividend was raised to US\$0.1, up 67% on Q1.

Year end	Revenue (\$m)	PBT* (\$m)	EPS* (c)	DPS (c)	P/E (x)	Yield (%)
12/12	33.2	9.0	50.5	20.0	24.8	1.6
12/13	33.6	8.3	50.8	24.0	24.7	1.9
12/14e	39.2	11.8	62.5	36.0	20.0	2.9
12/15e	44.7	15.4	81.5	46.0	15.4	3.7

Note: PBT and EPS are normalised and exclude exceptional items and amortisation of intangibles.

Q214 Market Data Licensing (MDL) revenue up 41%

Q214 MDL revenue rose 41% compared with Q213 and was up 4% on Q114. From 1 January 2014 OTCM's new MDL pricing came into effect and this has benefited revenues. There have been minimal client losses as a result of the price increase, and the subscriber base has risen further with professional user licence subscriptions up 12% and non-professional ones 5%.

Encouraging regulatory development

FINRA, the US broker-dealer regulator, proposed various rule changes in July 2014, including ceasing operation of its own OTC bulletin board and withdrawing its proposal to create a Quotation Consolidation Facility (QCF). These proposed changes remove potential threats from OTCM's business model.

Large dividend increase

OTCM announced a 67% increase in the Q214 dividend compared with that of Q114, reflecting its confidence in its business model and profit outlook. We have raised our full year 2014 DPS forecast to 36 cents per share from 27.6 cents per share. We have left our 2014 profit forecasts largely unchanged as a result of the Q2 results, but we have lowered our 2015 EPS forecasts by around 15% as a result of rising costs and because we now expect additional revenues from the corporate services initiatives to come through later than previously thought.

Valuation:

The shares have rallied considerably since the beginning of May, up almost 45%, and the share price is now closer to our valuation of \$17 per share. The dividend hike means the shares are giving a yield of 3%.

Financial services

28 August 2014

Price US\$12.52
Market cap US\$138m

Net cash (\$m) at June 2014	17.5
Shares in issue (exc treasury)	11.05m
Free float	60%
Code	OTCM
Primary exchange	OTCQX
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	3.3	29.1	61.5
Rel (local)	2.2	23.4	31.7
52-week high/low	US\$12.8	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

Q314 results	Early November 2014
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Q214 results

Exhibit 1: OTCM Q214 results					
\$000s	Q213	Q114	Q214	Q214 on Q114 (%)	Q214 on Q213 (%)
OTC Link ATS Trading services	2,955	2,902	2,772	(4)	(6)
Market Data Licensing	3,647	4,959	5,148	4	41
Corporate services	2,332	2,109	2,319	10	(1)
Gross revenues	8,934	9,970	10,239	3	15
Re-distribution fees and rebates	(449)	(603)	(581)	(4)	29
Net revenue	8,485	9,367	9,658	3	14
Operating expenses (exc depreciation and amortisation)	(6,150)	(6,207)	(6,609)	6	7
Depreciation and amortisation	(443)	(370)	(373)	1	(16)
Income from operations	1,892	2,790	2,676	(4)	41
Other income / net interest	(3)	1	6	0	N/M
Income before provision for income taxes	1,889	2,791	2,682	(4)	42
Taxes	(456)	(1,127)	(1,063)	(6)	133
Net income	1,433	1,664	1,619	(3)	13

Source: OTCM

OTCM reporting strong results for Q214 compared with Q213 with a 41% rise in income from operations largely arising from a 41% increase in Market Data Licensing revenue. However, the progress compared with Q114 was more modest, with revenue only slightly up and net income slightly down as a result of a 6% increase in operating expenses, which was largely due to a 14% increase in staff compensation (59% of total expenses) and a 21% rise in IT infrastructure and information expenses (16% of total expenses). This increase in staff compensation was the result of a 5% increase in headcount and a 16% rise in annual compensation rates. The “comp ratio” (compensation and benefits as a percentage of gross revenue) was 40% in Q214, slightly lower than the 41% in Q213, showing that OTCM has kept employee cost growth broadly in line with revenue growth.

Market Data Licensing (\$5.1m, 50% of Q214 revenue, H114 50%)

OTCM’s market data distribution network includes all the major financial data distributors and online brokerage firms. With effect from Q114 OTCM re-priced its MDL fees and this accounted for around 60% of the y-o-y revenue increase in Q214, with the remainder due to a further rise in the subscription base, with professional user licences rising 12% y-o-y and non-professional user licences 5%. OTCM has been active in expanding its distribution base over the last three years and seeks to expand it further. It provides the company with a good source of recurring revenue, which is unrelated to quarter-on-quarter fluctuations in trading activity.

OTC Link ATS trading services (\$2.8m, 27% of Q214 revenue, H114: 28%)

OTC Link ATS Trading Services links US broker-dealers and so provides liquidity and execution services for US and global equities. It enables FINRA member broker-dealers to display prices, attract order flow and conduct trade negotiations in equity and debt securities through a suite of quotation and trade-messaging products. Q214 revenue from OTC Link ATS trading services fell \$183,000 or 6% y-o-y in the quarter to \$2.8m. The decline arose as follows:

Exhibit 2: OTC Link ATS revenue decline Q214 compared with Q213

	\$000s	% fall y-o-y
Decline in quote position revenue	62	6%
Decline in QAP service fees	43	21%
Decline in trade message revenue	26	4%
Decline in subscription revenue	38	4%
Other items	14	
Total	183	6%

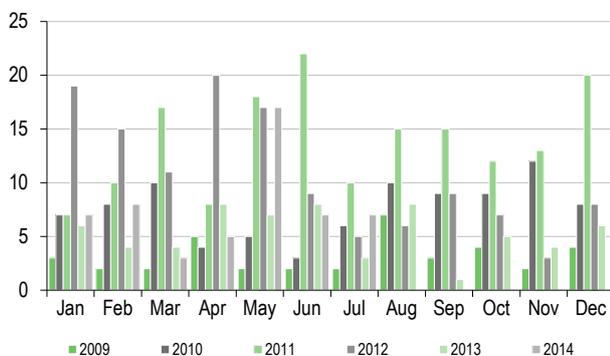
Source: OTCM

The number of users of OTC Link ATS Trading Services continues to decline with firms with less automation suffering competitive pressures. The lower the number of users there are, the lower the number of quote positions they make and the smaller the number of trade messages that are made. In other words, these revenue lines are linked. However, it should be noted that despite the fall in active users, total US\$ volume of trades in OTCQX, OTCQB and OTC Pink securities was flat Q214 compared to Q213 and for H114 it was up 34% compared with H113 indicating the market places remain very active.

Corporate services (\$2.3m, 23% of Q214 revenues, H114: 22%)

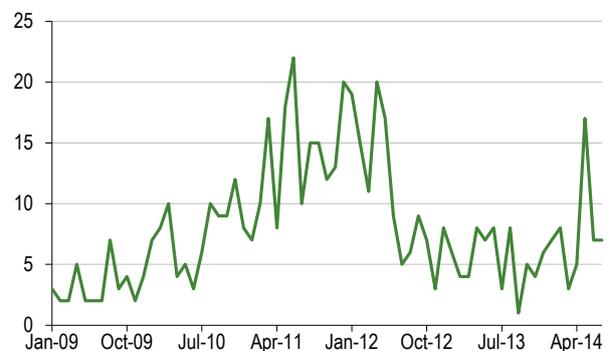
Q214 saw a continuation of revenue under pressure as weakness in the resource sector reduced the number of companies using OTCM services and overall revenue fell by 1% y-o-y, although this was less than the 4% y-o-y fall recorded in Q114 resulting in a H114 decline of 2% compared with H113. There was a 10% decrease in OTCQX subscription revenue primarily due to the lower number of OTCQX companies, but this was almost offset by an increase in premium subscription revenue, with a good growth in the number of companies using OTCM's OTC Disclosure & News Service.

Exhibit 3: New customers by month (OTCQX)



Source: OTC Markets, Edison Investment Research

Exhibit 4: Monthly progression new OTCQX customers



Source: OTC Markets, Edison Investment Research

Exhibit 5: Summary of companies listed by marketplaces

Number of securities	Dec 2009	Dec 2010	Dec 2011	Dec 2012	Dec 2013	18 Aug 2014
OTCQX US	17	21	29	44	38	49
OTCQX Int	61	138	285	356	332	309
OTCQX total	78	159	314	400	370	358
OTCQB**	3,321	3,851	3,625	3,401	3,143	2,554
OTC Pink* (total)	5,879	5,954	6,227	6,173	6,498	7,005
Total	9,278	9,964	10,166	9,974	10,011	9,917

Source: OTCM (www.otcm Markets.com/research/companyDirectory), Edison Investment Research. Note: *Of the OTC Pink number on 18 August, 3,951 were current info, 470 limited info and no info basis 2,584. **Actual launch April 2010.

Business update

OTCQB

OTCM introduced new standards for the OTCQB marketplace, which came into effect on 1 May 2014. The standards are designed to raise the credibility of the marketplace with investors, with more requirements on issuers. It will move from a purely domestic, non-fee market place to a global 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 sub-penny 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 by 120 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 OTCQB'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 \$20m, which compares with total corporate services revenue of U\$9.3m for 2013. The conversion rate of existing customers to the new premium marketplace will be key to revenue uplift. By 31 July 2014 36 OTCQB companies had already moved to the premium service. 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.
- The number of potential alternative providers has diminished with FINRA's OTC Bulletin Board's potential closure.

OTCQX Banks

On 7 March 2014 OTCM announced the creation of a new marketplace for community and regional banks. OTCQX Banks launched on 21 May 2014 and its key features 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 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 the OTCQB marketplace, and we expect these to be initially targeted to earn the incremental fees from the increased functionality of OTCQX Banks. To qualify for OTCQX, banks must appoint a corporate broker that is a FINRA member and specialises in trading in and advising banks. At launch, some six brokers were approved by OTCM to act as corporate brokers to banks, including KBW. It may also be expected that the development of closer relationships with corporate brokers will be a source of introduction for new business in due course.

Valuation

On our estimates, OTCM is trading on a 2015e P/E of c 15x, similar to the US equity market. OTCM is a unique company, so peer comparisons to assess its value are not straightforward. Around 50% of its revenues are earned selling its data and a large proportion of its trading services and corporate service fees are earned on a subscription basis rather than on the number of trades, as at an investment bank or an exchange. Moreover, unlike the former it does not have position risk. Financial services information providers such as Markit and MSCI are trading on forward P/Es of over 20x, so OTCM is not as highly rated in P/E terms.

Long-term valuation techniques depend crucially on long-term growth assumptions. Prospective net cash is US\$19.4m at the end of 2014, and with expected US\$10m of cash flow in 2015, OTCM would be worth US\$17 per share on a DCF basis if we assume a long-term growth rate of 3% and cost of capital of 9%.

Financials

We have fine-tuned our forecasts following the publication of Q2 results. We have left our 2014 revenue forecast largely unchanged, but have lowered it 3% for 2015 on the basis that increased revenue from corporate services is earned later than we previously anticipated. We have increased our expense forecasts by 4% in 2014 and 2015 compared with our previous estimate, as the increase in compensation costs recorded in Q214 seems to be permanent. The net result of these changes is that our EPS forecasts for 2014 and 2015 are 3% and 15% lower than previously. We have made significant increases to our 2014 and 2015 dividend forecasts of 30% and 42% respectively following the 67% hike in Q214 dividend.

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	38.7	39.2	1%	11.9	11.8	-1%	64.8	62.5	-3%	27.6	36.0	30%
2015e	46.3	44.7	-3%	17.9	15.4	-14%	96.4	81.5	-15%	31.7	46.0	45%

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	11,324	12,117
Market data licensing	13,680	14,081	14,741	21,007	23,200
Corporate services	7,498	9,305	9,331	9,278	12,000
Re-distribution fees and rebates	(1,944)	(2,168)	(2,188)	(1,842)	(1,869)
Revenue	30,763	33,184	33,640	39,240	44,711
Cost of Sales	(22,299)	(22,606)	(23,700)	(25,916)	(27,500)
Gross Profit	8,464	10,578	9,940	13,324	17,211
Operating Profit (before GW and except.)	8,464	10,578	9,940	13,324	17,211
Intangible Amortisation & depreciation	(1,358)	(1,622)	(1,642)	(1,568)	(1,800)
Operating Profit	7,106	8,956	8,298	11,756	15,411
Net Interest	(115)	30	0	7	0
Profit Before Tax (norm)	6,991	8,986	8,298	11,763	15,411
Tax	(2,139)	(3,509)	(2,667)	(4,706)	(6,164)
Profit After Tax (norm)	4,791	5,361	5,466	6,892	9,082
Profit After Tax (FRS 3)	4,852	5,477	5,631	7,057	9,247
Average Number of Shares Outstanding (m)	10.47	10.54	10.68	10.81	10.94
EPS - normalised (\$)	0.45	0.51	0.51	0.63	0.82
EPS - FRS 3 (\$)	0.46	0.51	0.51	0.64	0.83
Dividend per share (\$)	0.16	0.20	0.24	0.36	0.46
Gross Margin (%)	28%	32%	30%	34%	38%
EBITDA Margin (%)	28%	32%	30%	34%	38%
Operating Margin (before GW and except.) (%)	28%	32%	30%	34%	38%
BALANCE SHEET					
Fixed Assets					
Intangible Assets	291	291	291	291	291
Tangible Assets	5,143	5,066	4,184	4,216	3,966
Investments	209	209	210	210	210
Current Assets					
Debtors	7,194	6,481	4,980	5,585	6,208
Cash & cash investments	10,170	13,611	18,936	19,377	24,417
Current Liabilities					
Creditors	(3,695)	(3,589)	(3,909)	(3,270)	(3,299)
Long Term Liabilities					
Deferred rent	(926)	(786)	(608)	(508)	(508)
Other long term liabilities	(1,598)	(1,176)	(974)	(933)	(933)
Net Assets	12,872	14,515	18,704	23,264	28,647
NAV per share (\$)	1.21	1.34	1.70	2.09	2.55
CASH FLOW					
Operating Cash Flow (pre-tax)	11,086	12,175	10,662	10,307	17,618
Net Interest	(115)	30	0	7	0
Tax	(1,871)	(3,498)	(2,334)	(4,735)	(6,164)
Capex	(2,426)	(1,346)	(471)	(1,580)	(1,550)
Financing / investments	(1,536)	1,301	79	(24)	0
Dividends	(1,671)	(5,221)	(2,611)	(3,534)	(4,863)
Net Cash Flow	3,467	3,441	5,325	441	5,040
Opening net (debt)/cash	6,703	10,170	13,611	18,936	19,377
Closing net (debt)/cash	10,170	13,611	18,936	19,377	24,417

Source: OTC Markets, Edison Investment Research

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