

OTC Markets Group

Subscription base provides stability

Q3 results

Q3 results for OTC Markets Group (OTCM) provided further evidence of the benefits of its primarily subscription-based revenue model. The trading environment this year has been lacklustre but Q3 revenue and operating margin were only slightly lower. While costs were contained, IT spending increased, boding well for service enhancements and further quarters of 100% uptime. Since the half-year end an additional seven states have given Blue Sky recognition to OTCM's premium markets, a promising trend for longer-term development of the corporate customer base.

Year end	Revenue (\$m)	PBT* (\$m)	EPS* (\$)	DPS** (\$)	P/E (x)	Yield (%)
12/14	42.2	12.9	0.69	0.82	27.5	4.3
12/15	49.9	16.9	0.88	1.08	21.6	5.7
12/16e	50.7	16.7	0.90	1.16	21.1	6.1
12/17e	53.2	17.7	0.93	1.20	20.4	6.3

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 2016, and an estimated \$0.6 for 2017.

Third quarter results

Third quarter revenues were 2% down year-on-year, primarily reflecting a 14% reduction in OTC Link ATS revenues, which were held back by lower transactional volume and continued contraction in the number of broker-dealer participants as consolidation continues. Corporate Services saw only a small decline, while a 3.7% increase in market data fees pared back the overall reduction. Costs were slightly lower leaving operating profits down 4% and the operating margin down just one point to 36%. The 32nd quarterly dividend of \$0.14 was maintained and a special dividend of \$0.60 was announced, in line with last year.

Outlook

The economic and political outlook in the US is uncertain but economic growth is holding up well and the equity market reaction to the presidential election has been sanguine. As campaigning gives way to policy formation, corporate confidence may revive and stalled IPO activity return creating more favourable conditions for OTCM. The neighbouring Canadian market, important for OTCM, is already showing signs of revival. In the longer term, additional states conferring Blue Sky recognition, and initiatives to increase the attractions of OTCM's markets such as Q score, Research Market Place and Transfer Agent Verified Shares Program (see page 3) should all play into growth. Additionally the potentially transformational development of online capital raising could create a population of potential customers well suited to OTCM's low-cost, low-complexity, time-efficient offering.

Valuation

OTCM is currently trading close to our central DCF value of \$18.90/share (\$18.70 previously), but still trades at a moderate discount in terms of P/E when compared with financial information providers. The yield is over 6% including, or nearly 3% excluding, the special dividend.

Financial services

21 November 2016

Price **US\$19.00**
Market cap **US\$214m**

Net cash (\$m) at 30 September 2016	25.1
Shares in issue	11.3m
Free float	60%
Code	OTCM
Primary exchange	OTCQX
Secondary exchange	N/A

Share price performance



%	1m	3m	12m
Abs	1.1	14.0	26.2
Rel (local)	(0.9)	14.3	20.6
52-week high/low	US\$19.2	US\$14.5	

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 events

Q4 results	March 2017
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Q316 results: Limited impact from headwinds

OTC Markets' third-quarter figures showed revenues and operating income down 2% and 4% y-o-y respectively, continuing the relatively resilient performance seen in the second quarter against a less favourable market background: a testament to the benefits of the company's primarily subscription-based business model. The established trend for consolidation among broker dealers has continued while, cyclically, the dearth of IPOs and subdued corporate activity has contributed to a slower pace of company client recruitment, which in turn has meant a reduction in the number of corporate clients. An important positive signal for the longer term is the continued addition of new states to the list according OTCQX and/or OTCQB Blue Sky recognition.

Key data points from the third-quarter results included:

- Among the **operating metrics** by business line, for OTC Link ATS the number of active broker dealer subscribers (108) was down 3.6% y-o-y, and dollar value traded was 1% lower. Total clients (1,949) for Corporate Services were down 7.5%, including a 9.5% reduction in corporate subscribers for OTCQB. Positively, the number of professional users of market data increased 5.6% to 22,096.
- The overall **revenue** decline of 2.2% y-o-y included a sharper 13.9% reduction at OTC Link ATS, but a 3.7% increase in market data licensing income. These changes reflected the operating metrics cited above and, for market data, the benefit of the introduction of an indirect access fee in January for users of third-party portals.
- **Expenses** were contained at a marginally lower level than in the prior year period. Compensation costs were flat, while professional fees and marketing costs fell, the latter partly as a result of a move towards digital marketing. On the other hand there was an 11% increase in IT expenses, reflecting investments made to improve the service offering and sustain 100% uptime for OTC Link ATS, which continued in Q3.
- As a result, the reduction in operating income was contained to 4.2% and the operating margin was only one point lower y-o-y at 36%. Changes in estimates related to apportionment of state and local taxes reduced the tax charge (to an effective rate of 32%) and although some adjustments will drop out, the continuing rate is likely to be lower than the previous rate of 39% for FY15 and FY14. **Diluted earnings per share** were unchanged at \$0.26.
- A 32nd quarterly **dividend** was declared at an unchanged level of \$0.14 and also, as last year, a special dividend of \$0.60.

Exhibit 1: Q316 results summary

(\$000s unless stated)	Q315	Q116	Q216	Q316	% change vs Q315	% change vs Q216
OTC Link ATS	2,939	2,754	2,658	2,530	(13.9)	(4.8)
Market data licensing	5,087	5,325	5,237	5,274	3.7	0.7
Corporate services	4,874	4,672	4,744	4,809	(1.3)	1.4
Gross revenues	12,900	12,751	12,639	12,613	(2.2)	(0.2)
Re-distribution fees and rebates	(602)	(593)	(584)	(557)	(7.5)	(4.6)
Net revenue	12,298	12,158	12,055	12,056	(2.0)	0.0
Operating expenses	(7,707)	(8,361)	(7,936)	(7,657)	(0.6)	(3.5)
Income from operations	4,591	3,797	4,119	4,399	(4.2)	6.8
Other income / net interest	6	(8)	4	11	83.3	175.0
Income before provision for income taxes	4,597	3,789	4,123	4,410	(4.1)	7.0
Taxes	(1,512)	(1,474)	(1,608)	(1,404)	(7.1)	(12.7)
Net income	3,085	2,315	2,515	3,006	(2.6)	19.5
Diluted EPS \$	0.26	0.20	0.21	0.26	0.0	23.8
Operating margin	37%	31%	34%	36%		

Source: OTC Markets Group

In our next table we have provided a further analysis of revenues for OTC Link ATS and the corporate services activities. These numbers are mainly inferred from percentage changes given in the management commentary so are subject to rounding errors and should be treated as indicative. There are Q3 reductions across the revenue lines within OTC Link ATS reflecting the reduction in active subscribers and lower quote and message volumes. The marked decline in quote position revenue in the nine months to end September is also influenced by fee changes last year that included the removal of quote fees for the two premium markets, OTCQX and OTCQB, with a partially offsetting increase in trade messaging fees also evident.

In corporate services there were declines for both OTCQX and OTCQB revenues in Q3, while the disclosure and news service, where activity can fluctuate with the level of announcements, saw an increase of over 20% y-o-y, partially reflecting a price increase implemented in February 2016. Looking at nine-month revenues, the increase of over 28% in OTCQB this year reflects the lower starting point for corporate clients in 2015. Since peaking in Q315, client numbers have contracted through higher non-compliance related and non-renewal reductions.

Exhibit 2: Revenue analysis for OTC Link ATS and Corporate services activities

(\$m unless stated)	Q315	Q216	Q316	% change vs Q315	9M15	9M16	9m % change y-o-y
OTC Link ATS							
Quote position	0.68	0.57	0.60	(12.2)	2.41	1.76	(27.0)
Trade messages	0.83	0.77	0.70	(15.9)	2.03	2.27	12.0
Market participant subscriptions	1.38	1.13	1.13	(18.2)	3.91	3.59	(8.2)
Other	0.04	0.19	0.10		0.56	0.32	(43.1)
Total	2.94	2.66	2.53	(13.9)	8.91	7.94	(10.9)
Corporate services							
OTCQB	2.30	2.28	2.22	(3.5)	5.30	6.80	28.3
OTCQX	1.64	1.69	1.44	(12.2)	4.48	4.60	2.6
Disclosure and news service	0.93	0.78	1.15	23.2	2.67	2.83	5.9
Total	4.87	4.74	4.81	(1.3)	12.45	14.23	14.2

Source: OTC Markets Group, Edison Investment Research

Since the end of the first half, a further seven states have given **Blue Sky recognitions**. These include Alaska, Colorado, Georgia and Kansas for OTCQX plus Mississippi, Nebraska and New Mexico for both OTCQX and OTCQB. This takes the total to 12 recognising OTCQX and 10 recognising OTCQB out of 44 states and jurisdictions that maintain manual exemptions. These generally permit secondary trading in securities in a state and if OTCM can continue to extend this recognition the attraction of OTCM's premium markets should progressively broaden.

In a further initiative to increase transparency within its OTC Link ATS network, OTCM has launched **Q Score**, a system that tracks liquidity metrics so that users can identify those participants that are better providers of liquidity beyond displayed quotation sizes.

The launch of **Research Marketplace** in collaboration with ACF Equity Research, Sidoti & Co and Edison provides companies with a choice of sources for sponsored research in order to have professionally prepared analytical reports available for investors and potential investors. This builds on the data driven research provided by Morningstar and crowd-sourced commentary from Seeking Alpha, providing a range of options for companies to increase transparency for investors.

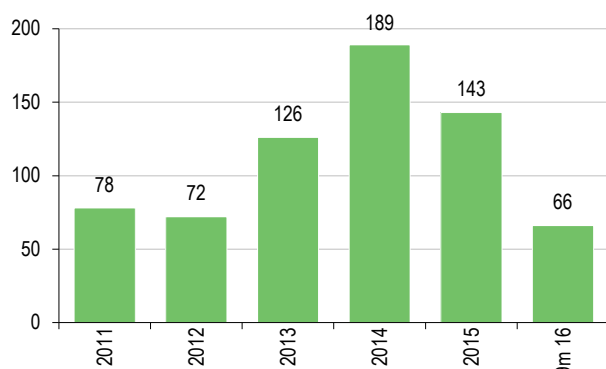
Transparency again lies behind the launch of the **Transfer Agent Verified Shares Program**, which uses technology to draw together information from transfer agents in order to verify the outstanding share capital for corporates. Undisclosed dilution is a source of risk for investors so as the system gains penetration this should increase confidence and willingness to invest in those covered.

Finally, OTCM has announced that **OTCQX rules** will be adjusted incrementally from January 2017 to remove unnecessary burdens on corporates by eliminating the ongoing OTCQX adviser requirement.

Current trading environment and outlook

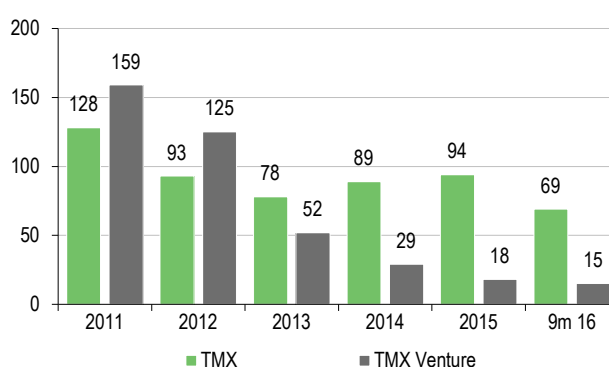
In this section we review some indicators of the equity capital markets background for OTCM and consider factors that might influence the company's trading outlook. We start by reviewing the number of IPOs on NASDAQ, TMX, TMX Venture and AIM. At NASDAQ the number of IPOs has been on a downtrend since a peak in 2014 and, the nine-month rate for 2016 on an annualised basis would be nearly 40% below the prior year. The number of IPOs on the Canadian TMX markets (Exhibit 4) is significantly below the levels seen in 2011/12, but, pro rata, TMX is running only slightly behind and TMX Venture is ahead of 2015.

Exhibit 3: Nasdaq – number of IPOs



Source: Nasdaq

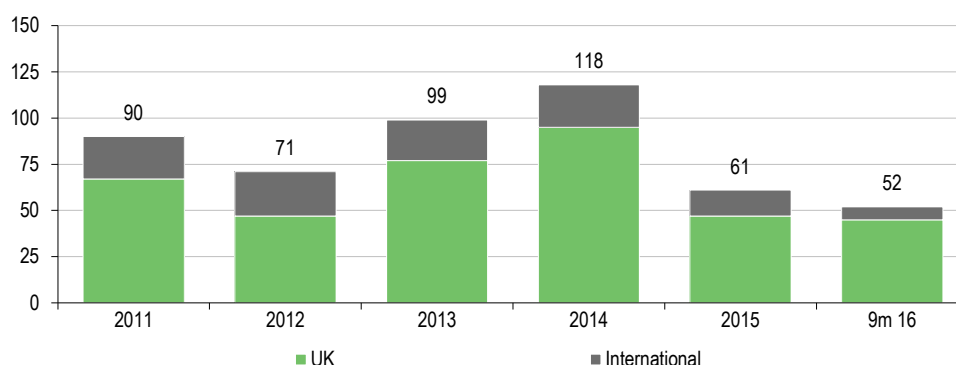
Exhibit 4: TMX and TMX Venture – number of IPOs



Source: TMX

In London the AIM market (Exhibit 5), like NASDAQ, is running well below its recent 2014 peak, but in terms of IPOs was actually ahead of 2015 on an annualised basis for the first nine months of the year despite a difficult macro background and a tapering off in the level of activity since May.

Exhibit 5: AIM – number of admissions



Source: AIM

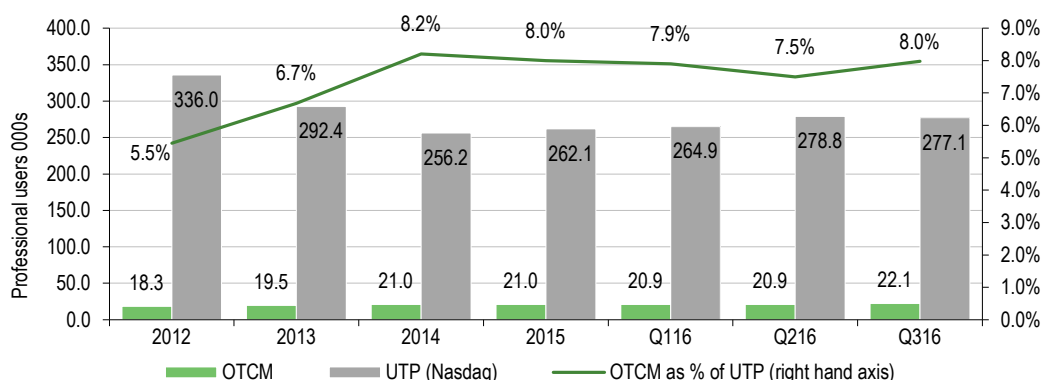
Trends across these markets have therefore been subdued but not uniformly so year to date. The economic outlook has remained uncertain but US GDP has shown a positive trend (Q3 +2.9%) and the IMF's October forecasts looked for growth of 1.6% in 2016 and 1.8% in 2017. Despite uncertainty the level of these markets has been perhaps surprisingly positive, with their indices all in positive territory (US and UK indices are up between 3% and 9% year-to-date) and the commodity-heavy Canadian indices ahead nearly 14% (S&P TSX) and 42% (S&P TSX Venture).

Looking ahead, the Trump victory in the US presidential election may well represent an important turning point in a range of policy areas including taxation, healthcare, trade and foreign relations. With Republicans also having control of the House and Senate there is potential for real change and, over coming months, markets will be trying to assess possible economic and stock specific

implications. After a brief dip most equity markets appear to have taken the result in their stride and, as the transition from campaigning to administration takes place, stalled corporate activity could start to revive as expectations are adjusted and policy positions are worked through.

Our next chart updates the comparison we have shown before between the number of professional users of OTCM's market data and users of UTP (Nasdaq). This shows an increase for both but with OTCM's faster growth in Q3 its user base is equivalent to a slightly higher percentage of the UTP number at 8%. This still represents relatively low penetration of the potential market and, if OTCM can continue to build the reputation of its premium markets and win attractive companies as clients, there should be good potential to increase market data revenue.

Exhibit 6: OTCM and UTP (Nasdaq) professional users



Source: OTCM, UTP Plan, Edison Investment Research

Political and market uncertainty could delay a recovery in corporate activity and hence prolong the period of more difficult conditions for client acquisition for OTCM's premium markets. However, the company has increased the focus in this area and, after an earlier phase of turnover in the sales team, it is now at full strength and the pipeline is described as promising.

On a medium-term view the company continues to work with the North American Securities Administrators Association and individual state regulators to increase the number of states recognising OTCQX and OTCQB. OTCM notes that Texas has proposed a change in its Civil Statutes ([14 October](#)) that would permit recognition of the two markets. While there can be no certainty over a level of recognition that would encourage a marked increase in corporate interest in joining these markets, OTCM notes that when Nasdaq listed Apple it did not have a full roster of 'Blue Sky' recognitions and that there might be a tipping point in the mid-30s that would also prompt further states to consider recognition.

Another potential medium-term positive driver for OTCM is the development of online or crowd funded capital raising facilitated by the Jumpstart Our Business Startups (JOBS) Act (including Regulation A+ and Regulation Crowdfunding). While there has currently been only one example of a company raising money through crowdfunding under Regulation A+ (and that company, Elio Motors, did choose to trade on OTCQX), as online funding matures OTCM sees good potential for such developing companies to be attracted to trading on its markets. OTCM aims for the costs for its corporate clients to be less than half the level of national securities exchanges while companies would also benefit from a lower administrative burden.

Potential challenges for OTCM should also be mentioned. These include competitive pressures, with successful companies tending to graduate to a national securities exchange; positively, such graduations also flag the successful role OTCM's platforms play in corporate development. Exchanges and new platforms could seek to compete more directly with OTCM's offering, in the process putting pressure on fees. Changes in regulation can impose costs (as with Regulation Systems Compliance and Integrity – SCI) or impinge on revenues (for example FINRA's 2009

proposal for a Quotation Consolidation Facility – QCF– that if implemented could affect a part of market data revenues that account for c 18% of total gross revenues). OTCM has successfully invested to address Regulation SCI and FINRA's QCF proposal has not seen any recent reported activity. Finally, in its Q3 report, OTCM mentions a proposal FINRA published for comment in August involving changes in its inter-dealer quotation system to include any OTC equity security, rather than only 'reporting companies'. This 'over-the-counter display facility' (ODF) is proposed as a backup to OTCM's OTC Link ATS and, subject to a volume hurdle, FINRA-member broker dealers would be required to connect to the system and participate in testing. OTCM plans to oppose the proposal indicating that it would be anti-competitive and that ODF is not likely to achieve the stated goals. Further details are set to be given in OTCM's submission due before 29 November, but on the Q3 call the company noted that ODF would not offer an electronic trading capability and would entail significant costs. OTCM indicates that it is unable to estimate a potential impact on revenues based on the proposal as currently drafted.

Drawing these remarks together, the economic background, while still uncertain, has been more resilient than many forecasters feared and, as the political background in the US starts to become clearer, both corporate and equity market confidence could build, providing a better background for both IPOs and OTCM's client signings. Regulatory and competitive risks remain features to monitor but, on a longer view, the two main opportunities for OTCM are first, the potential to continue to enhance the status and appeal of its premium markets through additional services and achieving wider Blue-Sky recognition and, second, to capitalise on development of still nascent online capital raising platforms.

Financials

Following the third quarter results our revenue and pre-tax profit estimates are effectively unchanged (see Exhibit 7), with small increases for market data income offsetting slightly lower OTC Link ATS revenues. As we highlighted in our [previous note](#), revenues are set to benefit between 2016 and 2017 from price increases for c 40% of OTCQB companies that move from a promotional fee of \$7,500 per annum to \$10,000, while those OTCQX companies that were clients in 2015 will move from \$15,000 to \$20,000. The lower tax rate seen in the third quarter and assumed for future periods (we assume 36% for 2017) results in increases of 4% and 5% in our earnings estimates for this year and next.

Exhibit 7: Earnings revisions

	Gross revenue (\$m)			PBT (\$m)			EPS (\$)			Dividend (\$)		
	Old	New	% change	Old	New	% change	Old	New	% change	Old	New	% change
2016e	50.7	50.7	0%	16.6	16.7	0%	0.86	0.90	4%	1.16	1.16	0%
2017e	53.3	53.2	0%	17.7	17.7	0%	0.89	0.93	5%	1.20	1.20	0%

Source: Edison Investment Research

At the end of the third quarter, cash on the balance sheet stood at \$25.1m compared with \$23.3m at the end of the second quarter. Assuming that the special dividend of \$0.60 to be paid in Q4 this year will be repeated next year, we estimate that cash will stand at just over \$20m and \$21m at the end of 2016 and 2017, respectively.

Valuation

We start with an updated version of our comparative P/E table (Exhibit 8), which includes major information providers MSCI and Markit (to reflect OTCM's subscription based fees and market data exposure) together with global exchange averages and values for the S&P 500 index. OTCM trades below the information providers and is similar to the exchanges but above the broad market index. Further Blue-Sky recognitions and evidence of a pick-up in the environment for corporate activity could be catalysts for a higher rating.

Exhibit 8: OTCM comparative multiples

	Estimated P/E ratios (x)	
	FY16	FY17
MSCI	24.3	23.0
Markit	17.9	17.2
Average information providers	24.8	21.0
Average global exchanges	21.4	19.8
S&P 500	18.3	16.4
OTCM	21.2	20.4

Source: Bloomberg, Edison Investment Research. Note: Prices as at 11 October 2016.

A sensitivity table based on our discounted cash flow model is shown next with unchanged central assumptions including a discount rate of 9%, cash flow growth of 3% and a terminal value multiple of 10x giving a value of \$18.90 (\$18.70 previously). The small increase reflects the modest change in estimates outlined above.

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

Discount rate (right) 2018-26e growth	7%	8%	9%	10%	11%
2%	20.2	19.1	18.0	17.0	16.1
3%	21.3	20.1	18.9	17.8	16.9
4%	22.5	21.1	19.9	18.8	17.7
5%	23.8	22.3	21.0	19.7	18.6

Source: Edison Investment Research

Exhibit 10: Financial summary

\$000s	2014	2015	2016e	2017e
Year end 31 December				
PROFIT & LOSS				
OTC Link ATS	12,019	11,796	10,442	10,600
Market Data Licensing	20,334	20,610	21,136	21,575
Corporate Services	9,862	17,503	19,075	20,983
Revenue	42,215	49,909	50,653	53,158
Re-distribution fees and rebates	(2,388)	(2,379)	(2,324)	(2,475)
Net revenue	39,827	47,530	48,329	50,683
Operating expenses	(25,382)	(28,972)	(30,040)	(31,242)
EBITDA	14,445	18,558	18,289	19,441
Depreciation	(1,543)	(1,692)	(1,624)	(1,725)
Operating Profit	12,902	16,866	16,665	17,716
Net Interest	9	27	7	0
Profit Before Tax (norm)	12,911	16,893	16,672	17,716
Tax	(5,021)	(6,635)	(6,096)	(6,378)
Profit After Tax (FRS 3)	7,890	10,258	10,577	11,338
Profit After Tax (norm)	7,638	9,971	10,291	11,052
Fully diluted av. No. of shares (m)				
	11.1	11.3	11.5	11.9
EPS - normalised fully diluted (c)	68.58	88.32	89.71	93.03
Fully diluted EPS - FRS 3 (\$)	0.71	0.91	0.92	0.97
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	2,180	1,155
Investments	210	210	210	210
Current Assets				
Debtors	5,674	6,082	4,930	6,500
Cash & cash investments	20,272	23,925	20,244	21,292
Current Liabilities				
Creditors	(4,450)	(4,971)	(4,297)	(2,450)
Long Term Liabilities				
Deferred rent	(391)	(139)	(245)	(240)
Other long term liabilities	(954)	(867)	(1,092)	(1,087)
Net Assets	18,251	17,547	15,663	15,157
NAV per share (\$)	1.62	1.55	1.39	1.34
CASH FLOW				
Operating Cash Flow	16,985	22,400	15,660	21,387
Net Interest	9	27	7	0
Tax	(4,492)	(5,320)	(4,937)	(6,145)
Capex	(1,582)	(940)	(277)	(700)
Financing / investments	(475)	(420)	(1,081)	0
Dividends	(9,109)	(12,094)	(13,054)	(13,493)
Net Cash Flow	1,336	3,653	(3,681)	1,049
Opening net (debt)/cash	18,936	20,272	23,925	20,244
Closing net (debt)/cash	20,272	23,925	20,244	21,292

Source: OTC Markets Group accounts, Edison Investment Research

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