



OTC Markets Group Inc. (OTCM)

Near Term Trends Remain Muted, But Subscription Based Model Offsets Impact, In Our View, Strong Cash Flow And Improving Trends Provide Optimism In 2017; Maintain \$23 Price Target

| | <u>2015</u> | <u>2016</u> | | <u>2017E</u> | | <u>2018E</u> | |
|------|-------------|-------------|--------------|--------------|------------|--------------|-------------|
| | | <u>OLD</u> | <u>NEW</u> | <u>OLD</u> | <u>NEW</u> | <u>OLD</u> | <u>NEW</u> |
| Mar. | \$0.16 | \$0.20A | | \$0.21 | \$0.20 | \$0.24 | 0.23 |
| June | 0.20 | 0.21A | | 0.23 | 0.22 | 0.24 | |
| Sep. | 0.26 | 0.26A | | 0.26 | | 0.27 | |
| Dec. | <u>0.25</u> | <u>0.26</u> | <u>0.23A</u> | <u>0.26</u> | | <u>0.29</u> | <u>0.28</u> |
| EPS | \$0.88 | \$0.93 | \$0.90 | \$0.96 | \$0.94 | \$1.04 | \$1.02 |
| P/E | | | | | 20.3x | | 18.6x |

Note: NR = Not Rated. Risk Ratings: H = Highly risky; M = Moderately risky. 2015-2018E include a respective \$0.08, \$0.09, \$0.07 and \$0.07 in stock-based compensation expense. Sum of quarterly EPS may not equal full-year total due to rounding and/or change in share count. NC=Not covered by Sidoti & Co., LLC.

| Year | 2009 | 2010 | 2011 | 2012 | 2013 | 2014 | 2015 | 2016 | 2017E | 2018E |
|------------|--------|--------|--------|--------|--------|--------|--------|--------|--------|--------|
| Rev.(Mil.) | \$24.1 | \$28.0 | \$30.8 | \$33.2 | \$33.6 | \$39.8 | \$47.5 | \$48.6 | \$49.0 | \$53.7 |
| GAAP EPS* | \$0.33 | \$0.28 | \$0.45 | \$0.51 | \$0.51 | \$0.69 | \$0.88 | \$0.90 | \$0.94 | \$1.02 |

* Revenue is net of redistribution fees.

Description: OTC Markets Group, Inc. (www.otcmkt.com) operates three lines of business centered on 10,000 U.S. and global securities clients. The company offers a cost-effective solution to penetrate the U.S. securities market, while providing a host of services that connect brokers and dealers, organize markets, and ultimately monetize OTC's vast database of information. OTC's three lines of business are Link ATS (24% of revenue), Market Data (41%) and Corporate Services (35%). Headquarters are in New York, NY.

- Reported 4Q:16 EPS of \$0.23 compares to \$0.25 a year ago and was modestly below our \$0.26 estimate, due largely to slightly weaker revenue trends than we forecasted, and the impact of higher costs.
- Revenue of \$12.9 million declined 1% from the \$13.1 million recorded in 4Q:15 and was below our \$13.1 million forecast; both Link and Corporate Services declined 9% and 1%, respectively, offset by 2% growth in Market Data.
- The operating margin of 35.8% in 4Q:16, compared with 38.5% in 4Q:15, was hurt by the revenue decline on a modestly higher operating cost structure.
- We fine tune our forecasts as we estimate revenue growth will be restrained near term, due to the weak IPO market and consolidation in the broker dealer sector. However, we note recent activity seems to be accelerating.
- OTCM exited 4Q:16 with a cash balance of \$25 million (\$2.21 per share) and in 2016 returned \$14.8 million in cash back to shareholders in the form of quarterly and special dividends, as well as share repurchases, up from \$12.9 in 2015.
- Our unchanged \$23 price target is based on an unchanged 22x our lowered 2018 EPS forecast of \$1.02 (from \$1.04).

OTCM reported 4Q:16 EPS of \$0.23. Revenue of \$12.9 million was down 1%, year over year, and just below our \$13.1 million forecast. On a segment basis, revenue increased 2% in Market Data, offset by declines of 9% and 1% in the Link and Corporate Service segments, respectively. Revenue trends are reflecting the weaker IPO market and industry consolidation among broker dealers, mitigated somewhat by new product offerings. The operating margin of 35.8% declined 270 basis points, compared with 4Q:15, and missed our 38.2% forecast. Operating costs of \$7.7 were up modestly growing 3%, year over year, but as a percentage of sales increased to 59.7%, versus 57.0% of sales due to the sales decline. Net income of \$2.7 million decreased 6% from 4Q:15, compared with our \$3.0 million

NR

Price Target: \$23

Price: \$20.75

Risk Rating: H

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Key Statistics

| | |
|-------------------------------|--------|
| Analysts Covering | 2 |
| Market Cap (Mil) | \$230 |
| Enterprise Value | \$212 |
| 52-Week Range (US OTC) | 25-16 |
| 5-Year EPS CAGR | 12% |
| Avg. Daily Trading Volume | 4,000 |
| Shares Out (Mil) | 11.265 |
| Float Shares (Mil) | 6.248 |
| Insider Ownership | 47% |
| Institutional Holdings | 53% |
| Annualized Dividend | \$0.56 |
| Dividend Yield | 2.7% |
| FCF Per Share (2018E) | \$1.38 |
| FCF Yield (2018E) | 6% |
| Net Cash Per Share (2018E) | \$3.76 |
| Price to Book Value | 11.2x |
| Return on Equity (2018E) | 38.8% |
| Total Debt to Capital | Nil |
| Interest Coverage Ratio | N/A |
| Short Interest % | N/A% |
| Short Interest Days To Cover | N/A |
| Russell 2000 | 1,414 |
| Russell 2000 – Last 12 Months | 36.7% |
| OTCM – Last 12 Months | 32.9% |



OTC Markets Group Inc.

Source: FactSet Prices

estimate, leading to EPS of \$0.23, just below our \$0.26 forecast and flat with the prior year.

| Exhibit 1: OTCM 4Q:16 Review | | | | | |
|--------------------------------------|----------------|----------------|-------------------|----------------|--------------------------|
| \$ in millions except per share data | | | | | |
| | <u>4Q:15 A</u> | <u>4Q:16 A</u> | <u>YoY Change</u> | <u>4Q:16 E</u> | <u>Estimate Variance</u> |
| Revenue | \$13,055.0 | \$12,878.0 | (1.4%) | \$13,079.1 | (1.5%) |
| Operating Income | \$5,031.0 | \$4,612.0 | | \$4,996.2 | |
| Operating Margin | 38.5% | 35.8% | (7.1%) | 38.2% | (6.2%) |
| Net Income | \$2,852.0 | \$2,693.0 | (5.6%) | \$2,967.7 | |
| Profit Margin | 21.8% | 20.9% | | 22.7% | (7.8%) |
| EPS | \$0.25 | \$0.23 | (8.9%) | \$0.26 | (11.5%) |

Sources: Company reports and Sidoti & Company, LLC. estimates.

While we expect demand to remain muted in the near term, we note a number of positive takeaways from the 4Q:16 earnings report. In our view one of the highlights in the 4Q:16 release and conference call related to eight additional states recognizing OTCM's OTCQX and OTCQB markets for Blue Sky exemption status. This brings the total to 20 states currently that recognize at least one of the two markets; this result was much stronger than we had anticipated. The company has commented that at 30 states recognizing either OTCQX or OTCQB for exemption status could potentially be a tipping point positively for the company. We think that as OTCM gets more states to recognize the OTCQX and OTCQB markets for exemption status, this will help drive newer companies to OTCM because of the lower cost associated with these markets. Additionally, while Regulation A+ likely is still three to five years away from being a major revenue growth opportunity for OTCM, we think these exemptions will help substantially. Regulation A+ simplifies the process of seeking capital for companies looking to raise less than \$50 million of proceeds. While early in the adoption of this new path to market for smaller companies, Elio Motors (OTCQX: ELIO, NC) in February 2016 was first to list on the OTCQX Best Market, raising \$17 million via crowdfunding. We note that a number of crowdfunding platforms are forming. In our view, this should set the stage for more companies to use this pathway to raise capital. Lastly the company's CFO Bea Ordonez commented that the pace at which new companies are signing up with the OTCQX and OTCQB markets has picked up in recent months and highlighted that the 33 companies joining in February represented one of the strongest showings seen in a number of quarters. While we think OTCM's near-term trends will remain muted due to the aforementioned headwinds, the strong recurring revenue business model will lead to stable revenue and profit metrics until market trends improve, in our view. We forecast EPS of, \$0.94 in 2017 and \$1.02 in 2018, equating to growth of 1% and 9% respectively.

Strong balance sheet and consistent cash flow lead to significant return of capital to shareholders in 2016. OTCM exited 4Q:16 with net cash of \$25 million (\$2.21 per share). We model free cash flow per share of \$1.29 in 2017 and \$1.38 in 2018, leading to a cash balance of \$43 million or (\$3.76 per share) at the end of 2018. While the company's capital spending is relatively modest at less than \$1 million annually, cash flow historically was returned to shareholders in the form of a quarterly dividend, special dividends and share repurchases. In 2016 OTCM returned \$14.7 million to shareholders in the form of dividends and share repurchase, up from the prior years' \$12.9 million in capital returned to holders. We note that while it is likely there will be more special dividends, we model only quarterly dividends into our forecast.

We maintain a \$23 target on OTCM shares. This \$23 target is based on applying a multiple of 22x to our adjusted 2018 EPS forecast of \$1.02 (trimmed from \$1.04). OTCM shares currently trade at 19x and 18x our respective 2017 and 2018 EPS forecasts. In the last five years, OTCM ranged from 12x-21x forward EPS and averaged 16x. Peers in the corporate service-based industry trade at 17x-26x (average 20x) estimated 2017 EPS and 15x-24x (average 19x) the consensus 2018 EPS forecast. Although OTCM's lack of liquidity validates the discount to the peers, we view the recurring-revenue model, profit profile, significant operating leverage, capital allocation and dividend payments as offsets. Meanwhile, as crowdfunding is relatively nascent in the capital markets world, we expect that as it matures the door will open for additional companies to use OTC's services.

Key Risks

Trading liquidity

OTC MARKETS GROUP INC.

Table 1. OTC Markets Group Inc., Income Statement

(\$ in thousands, except where noted)

| | Mar | June | Sep | Dec | 2015 | Mar | June | Sept | Dec | 2016 | MarE | JuneE | SepE | DecE | 2017E | 2018E |
|--------------------------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|-----------------|
| OTC Link | \$3,044 | \$2,931 | \$2,939 | \$2,882 | \$11,796 | \$2,754 | \$2,658 | \$2,530 | \$2,631 | \$10,573 | \$2,616 | \$2,525 | \$2,505 | \$2,605 | \$10,251 | \$10,353 |
| Market Data | 5,233 | 5,169 | 5,087 | 5,120 | 20,609 | 5,325 | 5,237 | 5,274 | 5,218 | 21,054 | 5,432 | 5,342 | 5,485 | 5,427 | 21,685 | 22,769 |
| Corporate Services | 3,247 | 4,330 | 4,874 | 5,053 | 17,504 | 4,672 | 4,744 | 4,809 | 5,029 | 19,254 | 4,672 | 4,744 | 4,905 | 5,130 | 19,451 | 20,618 |
| Total Revenue | \$11,524 | \$12,430 | \$12,900 | \$13,055 | \$49,909 | \$12,751 | \$12,639 | \$12,613 | \$12,878 | \$50,881 | \$12,720 | \$12,611 | \$12,895 | \$13,161 | \$51,386 | \$53,740 |
| Redistribution fees | 600 | 600 | 602 | 577 | 2,379 | 593 | 584 | 557 | 583 | 2,317 | 611 | 605 | 606 | 579 | 2,401 | 2,511 |
| Net Revenue | \$10,924 | \$11,830 | \$12,298 | \$12,478 | \$47,530 | \$12,158 | \$12,055 | \$12,056 | \$12,295 | \$48,564 | \$12,109 | \$12,006 | \$12,289 | \$12,582 | \$48,985 | \$51,229 |
| Compensation | 4,958 | 4,763 | 4,684 | 4,311 | 18,716 | 5,237 | 4,967 | 4,665 | 4,720 | 19,589 | 5,279 | 4,918 | 4,836 | 4,830 | 19,863 | 20,359 |
| IT Infrastructure | 1,157 | 1,145 | 1,239 | 1,319 | 4,860 | 1,340 | 1,375 | 1,378 | 1,376 | 5,469 | 1,399 | 1,375 | 1,418 | 1,382 | 5,574 | 5,467 |
| Professional fees | 389 | 546 | 520 | 356 | 1,811 | 499 | 438 | 439 | 356 | 1,732 | 483 | 441 | 451 | 369 | 1,745 | 1,719 |
| Marketing & Advertising | 266 | 340 | 298 | 387 | 1,291 | 280 | 184 | 175 | 210 | 849 | 254 | 252 | 258 | 211 | 975 | 1,022 |
| Occupancy costs | 361 | 344 | 397 | 382 | 1,484 | 405 | 367 | 442 | 412 | 1,626 | 382 | 378 | 387 | 395 | 1,542 | 1,612 |
| D&A | 406 | 420 | 434 | 432 | 1,692 | 417 | 410 | 387 | 392 | 1,606 | 420 | 378 | 387 | 395 | 1,580 | 1,612 |
| General and administrative | 232 | 183 | 135 | 260 | 810 | 183 | 195 | 171 | 217 | 766 | 254 | 126 | 129 | 224 | 733 | 1,035 |
| Total Operating Costs | \$7,769 | \$7,741 | \$7,707 | \$7,447 | \$30,664 | \$8,361 | \$7,936 | \$7,657 | \$7,683 | \$31,637 | \$8,471 | \$7,869 | \$7,866 | \$7,804 | \$32,011 | \$32,825 |
| Operating Income | \$3,155 | \$4,089 | \$4,591 | \$5,031 | \$16,866 | \$3,797 | \$4,119 | \$4,399 | \$4,612 | \$16,927 | \$3,638 | \$4,136 | \$4,423 | \$4,777 | \$16,975 | \$18,404 |
| Other incorr (costs) | 16 | 7 | 6 | 0 | 0 | (8) | 4 | 11 | 2 | 8 | (2) | (2) | (2) | (2) | (7) | (7) |
| Pretax Income | \$3,171 | \$4,096 | \$4,597 | \$5,031 | \$16,866 | \$3,789 | \$4,123 | \$4,410 | \$4,614 | \$16,935 | \$3,636 | \$4,135 | \$4,421 | \$4,776 | \$16,968 | \$18,397 |
| Income Taxes | (1,315) | (1,704) | (1,512) | (2,104) | (6,635) | (1,474) | (1,608) | (1,404) | (1,921) | (6,407) | (1,418) | (1,612) | (1,459) | (1,863) | (6,352) | (6,837) |
| Net Income | \$1,856 | \$2,392 | \$3,085 | \$2,927 | \$10,231 | \$2,315 | \$2,515 | \$3,006 | \$2,693 | \$10,528 | \$2,218 | \$2,522 | \$2,962 | \$2,913 | \$10,616 | \$11,560 |
| Less restricted stock | (\$58) | (\$67) | (\$88) | (\$75) | (\$288) | (\$63) | (\$63) | (\$79) | \$0 | (\$205) | \$0 | \$0 | \$0 | \$0 | \$0 | \$0 |
| Net Income To Common | \$1,798 | \$2,325 | \$2,997 | \$2,852 | \$9,943 | \$2,252 | \$2,452 | \$2,927 | \$2,693 | \$10,323 | \$2,218 | \$2,522 | \$2,962 | \$2,913 | \$10,616 | \$11,560 |
| FD EPS | \$0.16 | \$0.20 | \$0.26 | \$0.25 | \$0.88 | \$0.20 | \$0.21 | \$0.26 | \$0.23 | \$0.90 | \$0.20 | \$0.22 | \$0.26 | \$0.26 | \$0.94 | \$1.02 |
| FD Shares Outstanding | 11,421 | 11,435 | 11,368 | 11,292 | 11,289 | 11,440 | 11,431 | 11,429 | 11,371 | 11,340 | 11,340 | 11,340 | 11,340 | 11,340 | 11,340 | 11,342 |
| Dividend | \$0.10 | \$0.14 | \$0.14 | \$0.14 | \$0.52 | \$0.14 | \$0.14 | \$0.14 | \$0.14 | \$0.56 | \$0.14 | \$0.14 | \$0.14 | \$0.14 | \$0.56 | \$0.56 |
| EBITDA | \$4,006 | \$4,912 | \$5,414 | \$5,807 | \$20,137 | \$4,677 | \$4,953 | \$5,170 | \$5,376 | \$20,176 | \$4,402 | \$4,900 | \$5,187 | \$5,541 | \$20,031 | \$21,460 |
| Growth Analysis | | | | | | | | | | | | | | | | |
| Revenue YOY Growth | 15.6% | 21.4% | 19.5% | 16.5% | 18.2% | 10.6% | 1.7% | (2.2%) | (1.4%) | 1.9% | (0.2%) | (0.2%) | 2.2% | 2.2% | 1.0% | 4.6% |
| Adjusted Net Income YoY Growth | 11.5% | 47.7% | 59.3% | 9.7% | 29.7% | 24.7% | 5.1% | (2.6%) | (8.0%) | 2.9% | (4.2%) | 0.3% | (1.5%) | 8.2% | 0.8% | 8.9% |
| Adjusted FD EPS YoY Growth | 5.9% | 43.1% | 56.8% | 9.0% | 27.9% | 24.5% | 5.2% | (3.1%) | (8.6%) | 2.4% | (3.3%) | 1.1% | (0.7%) | 8.5% | 0.8% | 8.9% |
| Margin Analysis | | | | | | | | | | | | | | | | |
| Operating Margin | 28.9% | 34.6% | 37.3% | 40.3% | 35.5% | 31.2% | 34.2% | 36.5% | 37.5% | 34.9% | 30.0% | 34.5% | 36.0% | 38.0% | 34.7% | 35.9% |
| EBITDA Margin | 36.7% | 41.5% | 44.0% | 46.5% | 42.4% | 38.5% | 41.1% | 42.9% | 43.7% | 41.5% | 36.4% | 40.8% | 42.2% | 44.0% | 40.9% | 41.9% |
| Adjusted Profit Margin | 16.1% | 19.2% | 23.9% | 22.4% | 20.5% | 18.2% | 19.9% | 23.8% | 20.9% | 20.7% | 17.4% | 20.0% | 23.0% | 22.1% | 20.7% | 21.5% |
| Tax Rate | 41.5% | 41.6% | 32.9% | 41.8% | 39.3% | 38.9% | 39.0% | 31.8% | 39.0% | 37.8% | 39.0% | 39.0% | 33.0% | 39.0% | 37.4% | 37.2% |

Sources: Company reports, Sidoti & Company, LLC estimates

Appendix

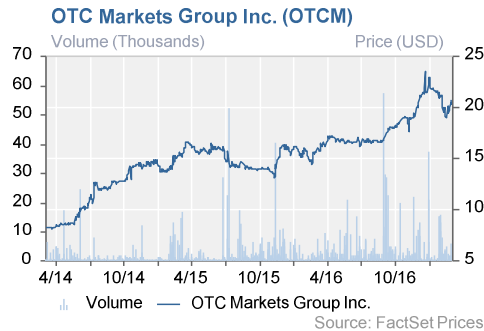
Required Disclosures

Required Disclosures

OTC Markets Group Inc. (OTCM-\$20.75) NR Price Target: \$23 Risk Rating: H

Rating and Price Target History Table

| Action | Date | Px | Rating | PT | Risk Rating |
|------------|----------|------|--------|----|-------------|
| Initiation | 9/1/16 | 17 | NR | 21 | H |
| PT | 12/23/16 | 21.6 | | 23 | |



Key Risks

Trading liquidity

Valuation:

We maintain a \$23 target on OTCM shares. This \$23 target is based on applying a multiple of 22x to our adjusted 2018 EPS forecast of \$1.02 (trimmed from \$1.04). OTCM shares currently trade at 19x and 18x our respective 2017 and 2018 EPS forecasts. In the last five years, OTCM ranged from 12x-21x forward EPS and averaged 16x. Peers in the corporate service-based industry trade at 17x-26x (average 20x) estimated 2017 EPS and 15x-24x (average 19x) the consensus 2018 EPS forecast. Although OTCM's lack of liquidity validates the discount to the peers, we view the recurring-revenue model, profit profile, significant operating leverage, capital allocation and dividend payments as offsets. Meanwhile, as crowdfunding is relatively nascent in the capital markets world, we expect that as it matures the door will open for additional companies to use OTC's services.

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APPENDIX CONTINUED

Sidoti Company Sponsored Research Rating System The Sidoti & Company, LLC *Company Sponsored Research* rating system consists of “*Moderately Risky*” (M) and “*Highly Risky*” (H) ratings. “*Moderately Risky*” suggests companies, that while still subject to relatively high price volatility, are characterized by more stable and predictable cash flow, a more established operating history, and an operating environment that is somewhat less competitive with a potential for loss of principal. “*Highly Risky*” suggests high risk equities of companies with a short or unprofitable operating history, limited or less predictable revenues, very high risk associated with success, significant financial or legal issues, or a substantial risk/loss of principal. As of 03/02/17, Company Sponsored Research Cap Research provides research on 2 companies, of which 1 (50%) are rated Moderately Risky and 1 (50%) are rated Highly Risky. *Earnings* targets and opinions concerning the composition of market sectors included in this report reflect analyst judgments as of this date and are subject to change without notice. A risk to our *earnings* targets is that the analyst’s estimates or forecasts may not be met. This report contains forward-looking statements, which involve risks and uncertainties. Actual results may differ significantly from such forward-looking statements. Factors that may cause such differences include, but are not limited to, those discussed in the “Risk Factors” section in the issuer’s SEC filings available in electronic format through SEC Edgar filings at www.sec.gov.

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Source

Key Statistics data is sourced from FactSet Research Systems

APPENDIX CONTINUED