

OTC Markets Group Inc. (OTCM)

Raise Price Target To \$27 (From \$23) As We Increase 2017 And 2018 EPS Estimates; Stronger Revenue Trends And Operating Leverage In OTCM's Business Model Drive 2Q:17 EPS Beat

	2015	2016	2017E		2018E	
			OLD	NEW	OLD	NEW
Mar.	\$0.16	\$0.20	\$0.26A		\$0.28	
June	0.20	0.21	0.24	0.26A	0.26	0.28
Sep.	0.26	0.26	0.26	0.27	0.26	0.29
Dec.	<u>0.25</u>	<u>0.23</u>	<u>0.27</u>		<u>0.29</u>	
EPS	\$0.88	\$0.90	\$1.03	\$1.06	\$1.08	\$1.14
P/E			23.8x		22.1x	

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	\$49.9	\$50.9	\$53.7	\$56.2
GAAP EPS*	\$0.33	\$0.28	\$0.45	\$0.51	\$0.51	\$0.69	\$0.88	\$0.90	\$1.06	\$1.14

* 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.

- **OTCM reported 2Q:17 EPS of \$0.26, versus our expectation of \$0.24 and the 2Q:16 result of EPS of \$0.21, with the increase driven by a combination of stronger revenue and operating leverage.**
- **Revenue of \$13.1 million increased 9% from the \$12.1 million recorded in 2Q:16 and was above our \$12.2 million forecast, with Corporate Services revenue up 21% and Market Data up 5%, somewhat offset by a 6% decline in Link revenue.**
- **The operating margin reached 36.7% in 2Q:17, compared with 34.2% in 2Q:16 and well above our 34.5% forecast, and think this highlights the operating leverage that revenue has over fixed costs for OTCM.**
- **We now expect EPS of \$1.06 (from \$1.03) in 2017, representing nearly 15% growth. We estimate 2018 EPS will increase 7% to \$1.14 (from \$1.08) on stronger revenue trends and greater operating leverage.**
- **OTCM exited 2Q:17 with cash of \$23 million (\$1.96 per share), and the board of directors issued a \$0.14 quarterly dividend (the 35th consecutive dividend), while also acquiring 12,889 shares in 2Q:17.**
- **Our new \$27 price target (from \$23) is based on 24x our revised 2018 EPS forecast of \$1.14. (Our previous \$23 target was based on about 22x to our prior 2018 EPS forecast of \$1.08.)**

OTCM reported 2Q:17 EPS of \$0.26. Revenue of \$13.1 million increased 9% year over year and was above our \$12.2 million forecast. On a segment basis, revenue increased 21% in Corporate Services and 5% within Market Data sales, offset by a 6% decline in Link revenue. Strength in Corporate services was driven by a combination of new companies on the OTCQB and OTCQX and increased pricing in 2017 versus 2016, as well as a higher rate of retention versus the year-ago period. Market Data revenue growth of 5% increased largely due to the rise in non-professional user licenses and greater use of compliance analytics data. LINK revenue fell 6%, with the decline attributable to a decline overall market

NR

Price Target: \$27

Price: \$25.25

Risk Rating: H

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Key Statistics

Analysts Covering	2
Market Cap (Mil)	\$280
Enterprise Value	\$277
52-Week Range (US OTC)	26-17
5-Year EPS CAGR	12%
Avg. Daily Trading Volume	2,000
Shares Out (Mil)	11.265
Float Shares (Mil)	6.248
Insider Ownership	47%
Institutional Holdings	53%
Annualized Dividend	\$0.56
Dividend Yield	2.2%
FCF Per Share (2018E)	\$1.42
FCF Yield (2018E)	5.6%
Net Cash Per Share (2018E)	\$3.68
Price to Book Value	18.6x
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	1,383
Russell 2000 – Last 12 Months	14.5%
OTCM – Last 12 Months	56.2%



participants. The operating margin of 36.7% expanded 250 basis points, compared with 2Q:16, and was ahead of our 34.5% forecast. Operating costs of \$8.3 million were up 5% year over year highlighting OTCM's ability to drive significant operating leverage inherent in its business model. Net income of \$3.0 million increased 24% from 2Q:16, leading to EPS of \$0.26, up 23% over the prior-year period.

Exhibit 1: OTCM 2Q:17 Review					
\$ in millions except per share data					
	<u>2Q:16A</u>	<u>2Q:17A</u>	<u>YoY Change</u>	<u>2Q:17 E</u>	<u>Estimate Variance</u>
Revenue	\$12,055.0	\$13,143.0	9.0%	\$12,186.2	7.9%
Operating Income	\$4,119.0	\$4,824.0		\$4,198.6	
Operating Margin	34.2%	36.7%	7.4%	34.5%	6.5%
Net Income	\$2,452.0	\$3,046.0	24.2%	\$2,738.2	
Profit Margin	20.3%	23.2%		22.5%	3.1%
EPS	\$0.21	\$0.26	23.3%	\$0.24	10.2%

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

Stronger trends accelerated in 2Q:17, and Blue Sky exemption is now in 25 states. Strength in 2Q:17 results was driven by several positive factors, in our view, ranging from stronger retention, lower non-compliance related issues, greater use of OTCM's data offerings, and new companies joining the OTCQX and OTCQB markets. OTCM reported a 93% retention rate for the OTCQX market, up from the prior-year's 89% rate, while within the OTCQB a combination of lower cancellation of service and non-compliance related issues led to a lower rate of removal, at 17%, down from 21% a year ago, resulting in larger annual subscription-based revenue. Companies added to the OTCQX and OTCQB through 2Q:17 continued at a strong pace adding 40 and 139 companies, respectively. Companies on the OTCQX were 355 versus 383 a year ago, while 912 were on the OTCQB, up from 877 a year ago. Given the backdrop of a stronger economy and the strongest rate of Form 211 filings in six quarters at 109, prospects for continued additions to both markets remain positive, in our view. In addition, the OTCQX and OTCQB markets are now recognized for Blue Sky exemption status in 25 states (as of 2Q:17), up from 21 states in 1Q:17. We note that 27 states was a tipping point for other markets to gain larger IPO transactions, and OTCM also could experience a greater rate of growth as we expect more states to continue to include the OTCQX and OTCQB for exemption status. Lastly, while we think 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 through crowdfunding. While early in the adoption of this new path to market for smaller companies, there have been several successful transactions, and we would expect over time the rate of greater adoption of Regulation A+ to increase. All in, we view OTCM's 2Q:17 results positively due to the stronger revenue growth and operating leverage inherent in its business model. We now forecast 2017 EPS of \$1.06, up from \$1.03, and increase our 2018 EPS forecast to \$1.14, up from \$1.08, following the 2Q:17 report.

OTCM's balanced capital allocation plan continued in 2Q:17. OTCM exited 2Q:17 with net cash of \$23 million (\$2.08 per share). We model free cash flow per share of \$1.38 in 2017 and \$1.42 in 2018, leading to cash of \$42 million (or \$3.68 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 conjunction with the 2Q:17 earnings release, OTCM announced its 35th consecutive quarterly dividend, which is currently at \$0.14. In addition, through 2Q:17 OTCM repurchased 80,034 shares for an average price of \$21.14 each. We note that while it is likely there will be more special dividends, we model only quarterly dividends into our forecast.

We raise our price target to \$27 (from \$23) on OTCM shares. Our new target is based on applying a multiple of 24x to our revised 2018 EPS forecast of \$1.14. (Our previous \$23 target was based on 22x our prior 2018 EPS forecast of \$1.08.) We increase our multiple on the improved revenue trends and stronger operating leverage, driving our 2018 EPS forecast increase. OTCM shares trade at 24x and 22x our respective 2017 and 2018 EPS forecasts. In the past three years, OTCM shares ranged from 16x-25x forward EPS and averaged 21x. Peers in the corporate service-based industry trade at 19x-28x (average 23x) estimated 2017 EPS and 18x-26x (average 21x) 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)

	2015	Mar	June	Sept	Dec	2016	MarA	JuneA	SepE	DecE	2017E	Mar	June	Sep	Dec	2018E
OTC Link	\$11,796	\$2,754	\$2,658	\$2,530	\$2,631	\$10,573	\$2,618	\$2,497	\$2,404	\$2,499	\$10,018	\$2,644	\$2,522	\$2,428	\$2,524	\$10,118
Market Data	20,609	5,325	5,237	5,274	5,218	21,054	5,450	5,522	5,485	5,427	21,884	5,723	5,798	5,759	5,698	22,978
Corporate Services	17,504	4,672	4,744	4,809	5,029	19,254	5,308	5,750	5,242	5,482	21,781	5,626	6,095	5,556	5,811	23,088
Total Revenue	\$49,909	\$12,751	\$12,639	\$12,613	\$12,878	\$50,881	\$13,376	\$13,769	\$13,130	\$13,408	\$53,683	\$13,993	\$14,415	\$13,743	\$14,033	\$56,184
Redistribution fees	2,379	593	584	557	583	2,317	624	626	617	590	2,457	672	692	646	617	2,627
Net Revenue	\$47,530	\$12,158	\$12,055	\$12,056	\$12,295	\$48,564	\$12,752	\$13,143	\$12,513	\$12,818	\$51,226	\$13,321	\$13,723	\$13,097	\$13,416	\$53,557
Compensation	18,716	5,237	4,967	4,665	4,720	19,589	5,566	5,243	4,858	4,934	20,601	5,737	5,492	5,085	5,052	21,366
IT Infrastructure	4,860	1,340	1,375	1,378	1,376	5,469	1,404	1,426	1,418	1,435	5,683	1,427	1,514	1,374	1,403	5,718
Professional fees	1,811	499	438	439	356	1,732	350	399	394	375	1,518	392	418	412	421	1,643
Marketing & Advertising	1,291	280	184	175	210	849	243	227	210	215	895	224	231	220	281	955
Occupancy costs	1,484	405	367	442	412	1,626	395	451	394	402	1,642	420	432	412	421	1,686
D&A	1,692	417	410	387	392	1,606	395	399	394	402	1,590	420	432	412	421	1,686
General and administrative	810	183	195	171	217	766	161	174	131	228	694	238	187	137	281	843
Total Operating Costs	\$30,664	\$8,361	\$7,936	\$7,657	\$7,683	\$31,637	\$8,514	\$8,319	\$7,799	\$7,991	\$32,623	\$8,858	\$8,707	\$8,053	\$8,279	\$33,897
Operating Income	\$16,866	\$3,797	\$4,119	\$4,399	\$4,612	\$16,927	\$4,238	\$4,824	\$4,714	\$4,827	\$18,603	\$4,464	\$5,016	\$5,044	\$5,136	\$19,660
Other income (costs)	0	(8)	4	11	2	8	14	22	10	10	56	10	10	10	10	40
Pretax Income	\$16,866	\$3,789	\$4,123	\$4,410	\$4,614	\$16,935	\$4,252	\$4,846	\$4,724	\$4,837	\$18,659	\$4,474	\$5,026	\$5,054	\$5,146	\$19,700
Income Taxes	(6,635)	(1,474)	(1,608)	(1,404)	(1,921)	(6,407)	(1,230)	(1,800)	(1,650)	(1,730)	(6,410)	(1,297)	(1,759)	(1,769)	(1,801)	(6,627)
Net Income	\$10,231	\$2,315	\$2,515	\$3,006	\$2,693	\$10,528	\$3,022	\$3,046	\$3,074	\$3,107	\$12,249	\$3,176	\$3,267	\$3,285	\$3,345	\$13,073
Less restricted stock	(\$288)	(\$63)	(\$63)	(\$79)	\$0	(\$205)	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0	\$0
Net Income To Common	\$9,943	\$2,252	\$2,452	\$2,927	\$2,693	\$10,323	\$3,022	\$3,046	\$3,074	\$3,107	\$12,249	\$3,176	\$3,267	\$3,285	\$3,345	\$13,073
FD EPS	\$0.88	\$0.20	\$0.21	\$0.26	\$0.23	\$0.90	\$0.26	\$0.26	\$0.27	\$0.27	\$1.06	\$0.28	\$0.28	\$0.29	\$0.29	\$1.14
FD Shares Outstanding	11,289	11,440	11,431	11,429	11,371	11,340	11,520	11,520	11,520	11,520	11,520	11,511	11,511	11,511	11,511	11,511
Dividend	\$0.52	\$0.14	\$0.14	\$0.14	\$0.14	\$0.56	\$0.14	\$0.14	\$0.14	\$0.14	\$0.56	\$0.14	\$0.14	\$0.14	\$0.14	\$0.56
EBITDA	\$20,137	\$4,677	\$4,953	\$5,170	\$5,376	\$20,176	\$5,198	\$5,861	\$5,751	\$5,864	\$22,674	\$5,501	\$6,053	\$6,081	\$6,173	\$23,808
Growth Analysis																
Revenue YOY Growth	18.2%	10.6%	1.7%	(2.2%)	(1.4%)	1.9%	4.9%	8.9%	4.1%	4.1%	5.5%	4.6%	4.7%	4.7%	4.7%	4.7%
Adjusted Net Income YoY Growth	29.7%	24.7%	5.1%	(2.6%)	(8.0%)	2.9%	30.5%	21.1%	2.3%	15.4%	16.3%	5.1%	7.3%	6.9%	7.7%	6.7%
Adjusted FD EPS YoY Growth	27.9%	24.5%	5.2%	(3.1%)	(8.6%)	2.4%	29.6%	23.3%	4.2%	17.3%	14.5%	5.2%	7.3%	7.0%	7.8%	6.8%
Margin Analysis																
Operating Margin	35.5%	31.2%	34.2%	36.5%	37.5%	34.9%	33.2%	36.7%	37.7%	37.7%	36.3%	33.5%	36.6%	38.5%	38.3%	36.7%
EBITDA Margin	42.4%	38.5%	41.1%	42.9%	43.7%	41.5%	40.8%	44.6%	46.0%	45.7%	44.3%	41.3%	44.1%	46.4%	46.0%	44.5%
Adjusted Profit Margin	20.5%	18.2%	19.9%	23.8%	20.9%	20.7%	22.6%	22.1%	23.4%	23.2%	22.8%	22.7%	22.7%	23.9%	23.8%	23.3%
Tax Rate	39.3%	38.9%	39.0%	31.8%	39.0%	37.8%	28.9%	37.1%	35.0%	35.0%	34.4%	29.0%	35.0%	35.0%	35.0%	33.6%

Sources: Company reports, Sidoti & Company, LLC estimates

Appendix

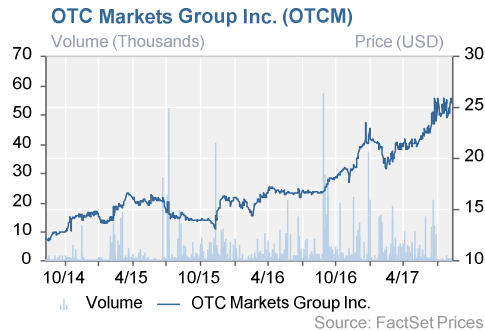
Required Disclosures

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OTC Markets Group Inc. (OTCM-\$25.25) NR Price Target: \$27 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:

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Sidoti Company Sponsored Research Rating System The Sidoti & Company, LLC *Company Sponsored Research* rating

APPENDIX CONTINUED

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 08/10/17, Company Sponsored Research Cap Research provides research on 4 companies, of which 3 (75%) are rated Moderately Risky and 1 (25%) 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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