OTC Markets Group

Q213 results

Investment for the future

Financial services

OTCM's (OTCQX: OTCM) Q213 total revenue grew 1% on Q212, with a 3% rise in market data licensing and 2% increase in issuer services offsetting a 2% fall in trading service revenue. The company has continued to invest heavily in both IT (up 11%) and marketing (up 80%). The increase in costs saw income before taxes drop 23%, although a lower tax burden saw net income down just 2%. The dividend was increased by 20%.

Year end	Revenue ($m)	PBT* ($m)	EPS* (c)	DPS (c)	P/E (x)	Yield (%)
12/11	30.8	7.0	0.45	0.16	17.8	2.0
12/12	33.2	9.0	0.51	0.45**	15.7	5.6
12/13e	35.5	9.2	0.56	0.24	14.3	3.0
12/14e	38.8	10.3	0.55	0.28	14.5	3.5

Note: *PBT and EPS are diluted and adjusted for the effects of restricted stock awards. **Includes special dividend.

Diversified revenues

While trading services revenue was down 2% on Q212, there has been some improvement in recent months with Q213 up 4% on Q113. We believe this reflects market appetite to trade and should not have been a surprise. Part of the Q2 on Q2 weakness reflects the one major account failing over Q2/Q312. Market data licensing was up 2% on Q113 and the company has recently announced a number of initiatives in this area. Issuer services saw revenue up 2% on Q212 but the comparators on H212 become more difficult. We note that the pressures from uncertainty in Europe and in resources companies have reduced new clients joining OTCM by c 40% year-on-year, and that management has a number of initiatives to improve sales and upsell to more premium products.

Investment spend

As previously announced, OTCM has continued to invest heavily in its IT infrastructure and marketing spend. The former incurs both internal expenses but also professional fees, while the latter saw an 80% increase on Q212. Overall, staff numbers were up six (to 78) and staff compensation and benefits up 10%. The IT spend will allow new products to be launched in due course. It should also introduce a degree of scalability that was not present before, allowing OTCM to take full advantage of any cyclical or structural growth.

Valuation: Over 20% upside

We have not revised our estimates or valuation materially for these results. H113 revenue is 47% of our full-year estimate and the improved trading conditions Q213 on Q113 mean we have not revised our forecasts. While costs were 50% of the full-year estimates, we believe there was a slight bias in the timing of marketing so these again are unchanged. We have made a small adjustment to the number of shares and equity following share-based compensation in the period and reflected the R&D tax credit in 2013 forecasts. Our valuation approaches indicate a fair value of $10.1 (previously $9.8).

14 August 2013

Price	$8.00
Market cap	$86m

Net cash ($m) as at end-June 2013	12.3
Shares in issue	10.8m
Free float	58%
Code	OTCM
Primary exchange	OTCQX
Secondary exchange	N/A

Share price performance

%	1m	3m	12m
Abs	0.0	(2.4)	10.3
Rel (local)	(0.8)	(5.9)	(8.5)
52-week high/low		US$8.45	US$7.0

Business description

OTC Markets Group (OTCM) operates open, transparent and connected financial marketplaces for 10,000 US and global securities. OTC Link ATS is operated by OTC Link LLC, member FINRA/SIPC and SEC regulated ATS.

Next event

Q313 results	Mid-Nov 2013

Analysts

Mark Thomas +44 (0)20 3077 5700

Martyn King +44 (0)20 3077 5745

financials@edisongroup.com

Edison profile page

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Quarterly results

Exhibit 1: Quarterly profit and loss ($000s)

	Q112	Q212	Q113	Q213		Q1 on Q1	Q2 on Q2	Q213 on Q113
Trading services	3,014	3,002	2,850	2,955		-5%	-2%	4%
Market data licensing	3,523	3,550	3,567	3,647		1%	3%	2%
Issuer services	2,031	2,278	2,208	2,332		9%	2%	6%
Gross revenues	**8,568**	**8,830**	**8,625**	**8,934**		**1%**	**1%**	**4%**
Re-distribution fees and rebates	(484)	(409)	(475)	(449)		-2%	10%	-5%
Net revenue	**8,084**	**8,421**	**8,150**	**8,485**		**1%**	**1%**	**4%**
Operating expenses (exc depreciation and amortisation)	(5,543)	(5,537)	(6,008)	(6,150)		8%	11%	2%
Depreciation and amortisation	(409)	(420)	(430)	(443)		5%	5%	3%
Income from operations	**2,132**	**2,464**	**1,712**	**1,892**		**-20%**	**-23%**	**11%**
Other income / net interest	5	4	(4)	(3)		-180%	-175%	-25%
Income before provision for income taxes	**2,137**	**2,468**	**1,708**	**1,889**		**-20%**	**-23%**	**11%**
Taxes	(857)	(1,004)	(509)	(456)		-41%	-55%	-10%
Net income	**1,280**	**1,464**	**1,199**	**1,433**		**-6%**	**-2%**	**20%**
Operating margin (inc from ops/net revenue)	26%	29%	21%	22%				
Tax rate	-40%	-41%	-30%	-24%				
Re-distribution fees and rebates as % revenue	-6%	-5%	-6%	-5%				
Re-distribution fees and rebates as % market data revenue	-14%	-12%	-13%	-12%				
Cost income ratio	-74%	-71%	-79%	-78%				

Source: OTCM, Edison Investment Research

Trading services

Q213 trading services revenue was down 2% on Q212 but up 4% on Q113. We do not believe this will have surprised the market given the more positive data from a number of exchanges. The fall on Q212 was driven by a 12% drop in revenues from OTC Dealer licences, connection fees and OTC Link subscriptions (significantly affected by the failure of one customer over Q2/Q312) partially offset by higher revenue from new products like QAP One Statement service fees. The investment in IT should allow further product launches in due course, diversifying revenue as well as providing a source for growth.

Market Data Licensing

Market Data Licensing is the biggest revenue division in the group, accounting for 41% of revenue. It has been a relatively stable revenue stream (up 3% on Q212 and 2% on Q113). There have been a number of new initiatives/distribution agreements announced since the end of June, which should support this income line going forward.

Exhibit 2: Announcements on market data initiatives since end-June 2013

Date	Announcement
23 July	OTC Markets Group Provides Real-Time Level 1 and Level 2 Data to TurnKey Brokerage Solutions' TurboTick Trading Platform
18 July	OTC Markets Group Provides Delayed Level 1 Quotes to YCharts
9 July	OTC Markets Group Delayed Level 1 Quotes and Marketplace Designations Now Displayed on MSN Money
8 July	OTC Markets Group Executes Enterprise Licensing Agreement with tradeMONSTER(TM) for Real-Time Level 1 Quotes

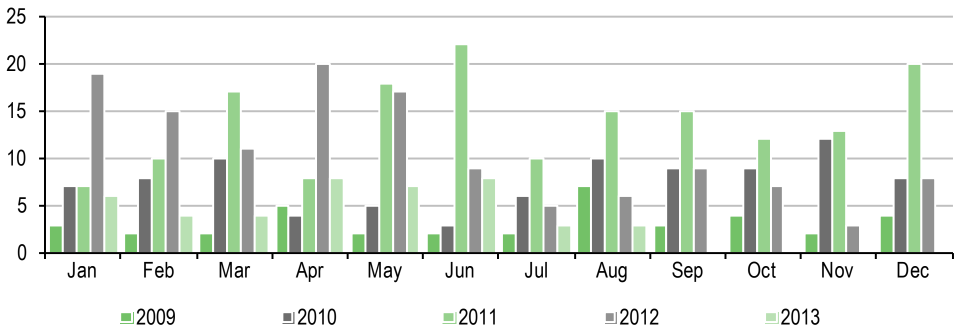
Source: OTCM, Edison Investment Research

OTCQX issuers and issuer service fees

OTCQX was very successful in attracting Canadian resource companies to the marketplace through 2011 and early-2012. Falling commodity prices in H212 and through 2013 to date has meant that this has not continued, as the financial position of many mining and resource companies has weakened. There was a greater number of non-renewals in January (13% against 5% a year ago) and slower growth in new companies signing on (see Exhibit 3 below). Overall, management sees churn as around one quarter from companies upgrading to a full exchange, half where the financials do not warrant being on the marketplace and one quarter where the companies have not seen the liquidity hoped for.

New customers to OTCQX have been joining at c 40% of the level seen in the same period in 2012. Additionally, declining values in mining interests saw a number of companies fall below the net asset criteria of OTCQX, thereby disqualifying them from inclusion in the market place. This led to an additional reduction of companies. The 13% non-renewals will reduce annual issuer services fees by around $750k (c 8% issuer fees, 2% off group revenue) and on current run rates, admission fees will be c $300k less, with a further loss of income from companies that no longer qualify for the OTCQX marketplace.

Exhibit 3: New companies joining OTCQX marketplace (monthly)



Source: OTCM announcements, Edison Investment Research (updated to 8 August 2013)

The net effect is that the total number of companies quoted on OTCQX has started to decline. OTCM is aiming to address each aspect of the volume story, namely by increasing customer acquisition, diversifying industrial concentrations away from mining/resources and slowing down the rate of non-renewal. It is also trying to upsell higher-value services. We expect further details on specific proposals to emerge through 2013.

Exhibit 4: Number of companies on OTCQX

	Dec 2009	Dec 2010	Dec 2011	Dec 2012	8 Aug 2013
OTCQX US	17	21	29	44	42
OTCQX Int	61	138	285	356	337
OTCQX total	**78**	**159**	**314**	**400**	**379**

Source: OTCM Edison Investment Research

Investment

We note that OTCM has been investing heavily in its IT infrastructure and data centre capacity as management broadens the range of products it provides, further improving the quality of revenue. IT expenses increased 11% on Q212 to $921k in Q213, with a major roll out in July. In Q213 there was also heavy marketing spend ($605k vs $336k in Q212 and $342k in Q113), especially in external advertising agency fees, which is expected to "taper" in Q313. The investment has not only been in technology, with the headcount increasing to 78 (and there was an increase in medical insurance costs also increasing expenditure). The investment has two major objectives – first to address the slow revenue growth through unit count growth (ie more customers across each business line) but also to position the group for any cyclical recovery. It has been well flagged and should not be a surprise to the market. Management has said that it believes some quarterly pressure is acceptable for building the franchise, but that it will "live within its means".

Regulation update

Regulation is an ongoing cost of doing business for OTCM. This quarter, the update on regulation took around five pages of the quarterly report – a greater space than the commentary on the Q213 financials. It can be summarised as follows:

- FINRA QCF proposal – nothing happened in the quarter. This proposal has potential significant adverse effects on market data licensing income, but has not been taken forward for a number of years.
- Jumpstart Our Business Startups Act (JOBS Act) – the Sec issued its final rules on 10 July for these proposals, which could have a beneficial impact on the business. Management comments that it hopes to see a JOBS Act 2 later this year.
- Tier Size Pilot is running from November 2012 to November 2013.
- Decimalisation – Spread Pricing Liquidity Act bill recently introduced into Congress. OTCM believes that this and the Tier Size proposals could reduce liquidity and is lobbying against their introduction in the current form.
- Regulation SCI – In March 2013 the SEC proposed a number of compliance and reporting requirements for Alternative Trading Systems. OTCM is supportive of the objectives but is, along with others, including NYSE and NASDAQ, lobbying against the specific proposals, arguing they are unduly burdensome and hinder efficient capital markets.

Valuation

Our Gordon's growth valuation model implies a value of $9.9 based on a sustainable ROE of 20% (well below 2013/2014e 30%+ levels), a cost of equity of 9% and growth of 5%.

Exhibit 5: Gordon's growth model and sensitivities

	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**
2013e NAV	2.11	2.11	2.11	2.11
Implied target price	**7.92**	**8.44**	**9.85**	**6.33**
Near term premium	25%	25%	25%	25%
Implied fair value	**9.90**	**10.56**	**12.32**	**7.92**
Difference		0.7	2.4	-2.0

Source: Edison Investment Research

Our cash flow approach (taking explicit forecasts for two years, 10 years on an assumed 5% growth, 9% discount rate and terminal value at 10x final cash flow) generates a value of $10.2.

Financials

Exhibit 6: Changes in estimates

	Normalised EPS			Normalised PBT			Revenue		
	Old	New	% chg	Old	New	% chg	Old	New	% chg
2011	0.45	0.45	0.0	7.0	7.0	0.0	30.8	30.8	0.0
2012	0.51	0,51	0.0	9.0	9.0	0.0	33.2	33.2	0.0
2013e	0.50	0.56	+12%	9.2	9.2	0.0	35.5	35.5	0.0
2014e	0.56	0.55	-2%	10.3	10.3	0.0	38.8	38.8	0.0

Source: Edison Investment Research

We have not changed our revenue or cost forecasts. The tax rate in 2013 year to date has been helped by R&D credit, which includes a catch up for 2012 and that we have now built into our estimates for 2013. Longer term we continue to assume a standard tax rate. There has also been a small increase in equity assumptions following the share based compensation reported in the period.

Exhibit 7: Key financials (profit and loss $000s)

Year ended Dec	2009	2010	2011	2012	2013e	2014e	2015e
Trading services	9,894	11,378	11,773	11,640	12,571	13,577	14,663
Market data licensing	10,911	11,858	13,111	13,555	14,911	16,402	18,042
Issuer services	3,227	4,803	8,067	9,831	10,000	11,000	12,000
Gross revenues	**24,032**	**28,039**	**32,951**	**35,026**	**37,482**	**40,978**	**44,705**
Re-distribution fees and rebates	(1,944)	(2,168)	(2,188)	(1,842)	(2,026)	(2,229)	(2,452)
Net revenue	**22,088**	**25,871**	**30,763**	**33,184**	**35,456**	**38,750**	**42,253**
Operating expenses (exc depreciation and amortisation)	(15,520)	(19,723)	(22,299)	(22,606)	(24,500)	(26,500)	(28,500)
Depreciation and amortisation	(835)	(1,017)	(1,358)	(1,622)	(1,800)	(2,000)	(2,000)
Income from operations	5,733	5,131	7,106	8,956	9,156	10,250	11,753
Other income / net interest	(89)	(69)	(115)	30	0	0	0
Income before provision for income taxes	**5,644**	**5,062**	**6,991**	**8,986**	**9,156**	**10,250**	**11,753**
Taxes	(2,138)	(2,127)	(2,139)	(3,509)	(2,976)	(4,100)	(4,701)
Net income	**3,506**	**2,935**	**4,852**	**5,477**	**6,180**	**6,150**	**7,052**
Diluted Adjusted EPS ($)	0.33	0.28	0.45	0.51	0.56	0.55	0.63
Operating margin (inc from ops/net revenue)	26%	20%	23%	27%	26%	26%	28%
Tax rate	-38%	-42%	-31%	-39%	-33%	-40%	-40%
Re-distribution fees and rebates as % revenue	-8%	-8%	-7%	-5%	-5%	-5%	-5%
Re-distribution fees and rebates as % market data revenue	-18%	-18%	-17%	-14%	-14%	-14%	-14%
Pre-tax profit margin	26%	20%	23%	27%	26%	26%	28%
Cost income ratio	-74%	-80%	-77%	-73%	-74%	-74%	-72%
ROE	58.0%	34.6%	43.8%	40.0%	36.9%	29.1%	27.4%
Revenue mix							
Trading Services	41%	41%	36%	33%	34%	33%	33%
Market data licensing	45%	42%	40%	39%	40%	40%	40%
Issuer services	13%	17%	24%	28%	27%	27%	27%

Source: OTCM, Edison Investment Research

Exhibit 8: Key financials – balance sheet ($000s)

Year ended Dec	2009	2010	2011	2012	2013e	2014e	2015e
Current assets							
Cash and Cash equivalents	**5,385**	**6,703**	**10,170**	**13,611**	**18,896**	**23,411**	**28,589**
Short term instruments	0	0	1,297	0	0	0	0
Accounts receivables net of allowances	5,861	5,329	7,194	6,481	7,000	7,750	8,500
Pre-paid income taxes	215	582	307	345	450	500	500
Prepaid expenses and other current assets	652	381	417	744	744	744	744
Deferred tax assets (net)	102	259	293	203	203	203	203
Total current assets	**12,215**	**13,254**	**19,678**	**21,384**	**27,293**	**32,608**	**38,536**
Property and equipment (net)	4,021	4,036	5,143	5,066	5,066	5,066	5,066
Goodwill	251	251	251	251	251	251	251
Intangibles	139	88	40	40	40	40	40
Security deposits	89	181	209	209	209	209	209
Deferred tax assets (net)	0	0	0	0	0	0	0
Total Non-Current assets	**4,500**	**4,556**	**5,643**	**5,566**	**5,566**	**5,566**	**5,566**
Total Assets	**16,715**	**17,810**	**25,321**	**26,950**	**32,859**	**38,174**	**44,102**
Current liabilities							
Accounts payable	791	387	629	721	600	600	600
Current portion of bank loan	786	92	0	0	0	0	0
Accrued expenses and other	2,180	1,970	3,066	2,868	3,000	3,000	3,000
Dividend payable	336	414	419	0	500	650	650
Income tax payable	0	0	0	0	0	0	0
Income tax reserve	0	372	109	0	0	0	0
Deferred revenue	2,731	4,299	6,628	7,670	8,670	9,670	10,670
Total Current Liabilities	**6,823**	**7,534**	**10,851**	**11,259**	**12,770**	**13,920**	**14,920**
Bank loan	1,246	0	0	0	0	0	0
Deferred rent	757	816	926	786	675	575	575
Deferred tax liabilities net	176	200	475	113	113	113	113
Income tax reserve	0	0	197	277	277	277	277
Total non-current liabilities	2,179	1,016	1,598	1,176	1,065	965	965
Total Liabilities	9,002	8,550	12,449	12,435	13,835	14,885	15,885
Net assets Inc non-controlling interests	**7,713**	**9,260**	**12,872**	**14,515**	**19,024**	**23,289**	**28,217**
Year-end no of shares	**8,408,942**	**10,480,945**	**10,615,433**	**10,830,885**	**10,930,885**	**11,030,885**	**11,130,885**
Equity NAV per share ($)	**0.917**	**0.884**	**1.213**	**1.340**	**1.740**	**2.111**	**2.535**

Source: OTCM, Edison Investment Research

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Berlin +49 (0)30 2088 9525
Friedrichstrasse 95
10117 Berlin
Germany

London +44 (0)20 3077 5700
280 High Holborn
London, WC1V 7EE
United Kingdom

New York +1 646 653 7026
245 Park Avenue, 39th Floor
10167, New York
US

Sydney +61 (0)2 9258 1162
Level 33, Australia Square
264 George St, Sydney
NSW 2000, Australia

Wellington +64 (0)4 8948 555
Level 15, 171 Featherston St
Wellington 6011
New Zealand