

OTC Markets Group

Q221 results

Revenue beat, positive business mix

While elevated US equity market volumes drove up OTC Markets Group's (OTCM) trading revenues 40% ahead of our expectations, higher P/E multiple divisions of Market Data Licensing and Corporate Services also exceeded (by 9% and 15% respectively). Net acquisition of corporate clients has accelerated, which bodes well despite a likely normalisation of trading activity. We raise our EPS forecast by 12% for 2021 and 19% for 2022. Management's confidence in the business has prompted it to increase the quarterly dividend to \$0.18 from \$0.15 and we expect the group to pay a special dividend of 65c in 2021 and 75c in 2022.

Year end	Revenue (\$m)	PBT (\$m)	EPS* (\$)	DPS** (\$)	P/E (x)	Yield (%)
12/19	62.8	18.0	1.25	1.25	33.7	2.7
12/20	71.2	21.4	1.53	1.25	27.4	2.7
12/21e	92.5	33.1	2.16	1.34	21.1	2.9
12/22e	84.1	30.5	2.06	1.41	22.2	3.1

Note: *Fully diluted and calculated after restricted stock award allocation. **Including special dividends of 65c each year for FY19–21e and 75c for FY22e.

Q221 summary: Boosted by strong trading volumes

OTCM reported a very strong second quarter, with gross revenues of \$25.5m, up 49% compared with Q220. Segmentally, this was led by OTC Link (+110%), which benefited from elevated US equity trading levels (albeit lower than Q121). Market Data Licensing (+25%) and Corporate Services (+40%) were also strong.

Expenses, including redistribution fees and transaction-based expenses, increased by 33%, reflecting volume-related costs and incentive compensation as well as increases in base salaries. This left pre-tax profit up 90% illustrating the operational gearing and, after a higher tax charge, diluted EPS increased by 65%.

Trading to normalise, but underlying trends positive

Following Q221, there are further signs that US equity trading activity continues to normalise, and we have assumed this in our forecasts while acknowledging that it is not possible to estimate with any degree of confidence. We reflect these trends in our estimates for OTC Link and, to some extent, Market Data Licensing. The positive trend in corporate clients joining OTCQX (530, up 10% quarter-on-quarter and 28% year-on-year) and OTCQB (1,020, up 6% quarter-on-quarter and 15% year-on-year) is likely to have longer-lasting benefits. We have increased our 2021 EPS estimate by 12%, which reflects a normalisation in trading but stronger market data and corporate services revenue, while our 2022 estimate has increased by 19%, reflecting a lower than expected decline in revenue in 2022.

Valuation

Following our estimate changes, the shares trade on a 2022 P/E of 22.2x, below the average for global exchanges (nearest peers) of 24.3x (see Exhibit 9). For both years, the multiples remain significantly below those of information providers (35.2x). The high proportion of subscription-based revenues and longer-term potential for development of OTCM's cost-effective markets are supportive factors.

Financial services

19 August 2021

Price **US\$45.50**
Market cap **US\$536m**

Net cash (\$m) at 30 June 2021 43.0

Shares in issue 11.7m

Free float 63%

Code OTCM

Primary exchange OTCQX

Secondary exchange N/A

Share price performance



%	1m	3m	12m
Abs	(7.1)	3.4	46.3
Rel (local)	(8.7)	(3.0)	12.7

52-week high/low US\$52.7 US\$29.5

Business description

OTC Markets Group operates the OTCQX, OTCQB and Pink financial markets for over 11,000 US and global securities. OTC Link LLC, a member of FINRA, operates OTC Link ATS and OTC Link ECN, both SEC-registered Alternative Trading Systems. Approximately 82% of revenues were of a subscription-based recurring nature in FY20 and 63% in Q221.

Next events

Q221 results August 2021

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Q221 results analysis

Exhibit 1 provides a summary of profit and loss figures, comparing the Q221 results with Q121 and Q220. In the comments below, we are comparing Q221 with Q220 unless stated.

Gross revenue increased by 49%, with the largest increase coming from OTC Link (a FINRA member broker-dealer that operates two Securities and Exchange Commission (SEC) registered Alternative Trading Systems), where trading volumes on OTC Link ECN and messaging volumes on OTC Link ATS drove a 110% increase in revenue (\$4m absolute increase, \$3.4m was driven by OTC ECN). OTC Link's commitment to ensuring the reliability of its core systems was validated by this period of continued high activity.

Market Data Licensing (distributes market data and financial information) revenue increased by 25%, with the main contributor being the growth in non-professional users as retail participation in equity markets increased. Growth in professional users and price increases were among the other factors at play.

Corporate Services (operates the OTCQX and OTCQB markets and offers issuers disclosure and regulatory compliance products) revenue growth of 40% was generated by a combination of strong additions in new clients for OTCQX and OTCQB markets (see Exhibit 2), price increases and increased demand for Virtual Investor Conferences' services.

Re-distribution fees, which relate to market data services, grew by 6% and transaction-based expenses (payments for liquidity provision on OTC Link ECN) were up 310% as a result of higher transaction activities.

Operating expenses (before depreciation and amortisation) were up 19%, with the main contributors being personnel costs and clearing and regulatory costs resulting from the expansion of ECN trading (see further detail in Exhibit 4).

At the **pre-tax profit** level, the increase was 90% to \$9.1m, while a higher tax charge of 22.7% versus 11.9% left diluted earnings up 65% at \$0.59 from \$0.36.

Exhibit 1: Profit and loss analysis					
\$000s	Q220	Q121	Q221	% change vs Q220	% change vs Q121
OTC Link	3,659	10,282	7,682	110	(25)
Market Data Licensing	6,858	7,899	8,586	25	9
Corporate Services	6,582	7,895	9,182	40	16
Gross revenues	17,099	26,076	25,450	49	(2)
Re-distribution fees and rebates	(706)	(741)	(746)	6	1
Net revenue	16,393	25,335	24,704	51	(2)
Transaction-based expenses	(607)	(3,539)	(2,487)	310	(30)
Revenues less transaction-based expenses	15,786	21,796	22,217	41	2
Operating expenses (excl. depreciation and amortisation)	(10,579)	(12,933)	(12,633)	19	(2)
Depreciation and amortisation	(415)	(444)	(441)	6	(1)
Income from operations	4,792	8,419	9,143	91	9
Other income/net interest	10	5	0	(100)	(100)
Income before provision for income taxes	4,802	8,424	9,143	90	9
Taxes	(571)	(1,586)	(2,071)	263	31
Net income	4,231	6,838	7,072	67	3
Diluted EPS (\$)	0.36	0.57	0.59	65	3
Operating margin (%)	29.2	33.2	37.0		
Tax rate (%)	11.9	18.8	22.7		

Source: OTCM, Edison Investment Research

Exhibit 2 shows how the corporate client base for the OTCQX and OTCQB markets has evolved from Q219. After a low point in Q120/Q220, the rate of new client additions for both markets improved with a markedly stronger second quarter.

Q221 showed a continuation of the strong momentum with 70 additions for OTCQX (OTC Markets' premium platform market providing efficient public trading without the complexity and cost of a national securities exchange listing) and 112 for OTCQB (a venture market providing public trading for entrepreneurial and development-stage companies and applies standards that promote price transparency and facilitate public disclosure. OTCQB is also open to international companies), representing 14.5% and 11.6% of the opening client base for each market respectively. At the same time, the rate of cancellations and downgrades was similar to previous quarters at 4.6% (OTCQX) and 5.6% (OTCQB), leaving net additions in the quarter at 48 and 58 companies respectively.

Out of the 70 new corporates joining OTCQX, 56 were international issuers and of the 112 joining OTCQB, 97 were international issuers. Management comments on increased sales in the UK office and a dedicated sales effort focused on the Australian market. This highlights the importance of the contribution by international companies to the group's growth profile and of the value that OTCM can offer to international companies seeking access to the US capital market at a lower cost than incumbent exchanges.

Exhibit 2: Evolution of OTCQX and OTCQB corporate client base

	Q219	Q319	Q419	Q120	Q220	Q320	Q420	Q121	Q221
OTCQX									
Start	414	421	436	442	414	415	441	461	482
Additions	30	31	32	9	19	44	34	52	70
Other (cancellations, downgrades)	(23)	(16)	(26)	(37)	(18)	(18)	(14)	(31)	(22)
End	421	436	442	414	415	441	461	482	530
Net change	7	15	6	(28)	1	26	20	21	48
OTCQB									
Start	941	916	915	907	893	885	874	902	962
Additions	38	53	43	28	45	62	94	83	112
Other (cancellations, downgrades)	(63)	(54)	(51)	(42)	(53)	(73)	(66)	(23)	(54)
End	916	915	907	893	885	874	902	962	1020
Net change	(25)	(1)	(8)	(14)	(8)	(11)	28	60	58

Source: OTCM, Edison Investment Research. Note: Start, end and additions (new sales) figures are reported, while the other figures (cancellations and compliance and other downgrades) are residual.

Exhibit 3 shows changes in operating expenses between Q220 and Q221. As noted earlier, the main drivers of the 19% change were increases in compensation, and professional and consulting costs, a continuation of the trend in Q121. Compensation and information technology costs remain a significant proportion of overall expenses, representing approximately 80% of total operating expenses. Higher incentive compensation combined with higher sales commissions (strong sales at OTCQX and OTCQB) were the key driver.

Exhibit 3: Analysis of operating expenses

\$000s	Q220	Q221	Absolute change	% change	Comments
Compensation and benefits	7,380	8,497	1,117	15.1	Headcount up 2 to 104, higher incentive compensation + higher commissions related to OTCQX and OTCQB sales
IT infrastructure and information services	1,560	1,876	316	20.3	Incremental data centre and network costs to support ECN growth
Professional and consulting fees	725	1,076	351	48.4	Higher ECN clearing/regulatory costs with volume
Marketing and advertising	167	280	113	67.7	Higher public relations spending offset by lower travel and entertainment spend
Occupancy costs	534	619	85	15.9	Primarily driven by higher estimated real estate taxes
Depreciation and amortisation	415	441	26	6.3	Primarily driven by IT infrastructure enhancements in 2020
General, administration and other	213	285	72	33.8	Higher payment processing fees and bad debt expenses partially offset by a decrease in office expenses
Total	10,994	13,074	2,080	18.9	

Source: OTC Markets Group, Edison Investment Research

Exhibit 4 sets out operating and related revenue data, showing year-on-year and quarter-on-quarter changes. OTC Link data show substantial increases in trading volumes in line with US equity markets generally and the growth in number of ECN subscribers. For Corporate Services, analysis of the growth in OTCQX and OTCQB client numbers has been shown above (see Exhibit 2). In Market Data Licensing, the increase in non-professional market data subscribers remains impressive and reflects high retail investor participation, a phenomenon that began during the COVID-19 lockdowns. We note that the number of non-professional users has been volatile historically and, should equity markets correct, we see risk of a pullback here.

Exhibit 4: Operating and related revenue data					
	Q220	Q121	Q221	% change y-o-y	% change q-o-q
OTC Link					
Dollar volume traded					
OTCQX	18,807	77,599	60,030	219.2	(22.6)
OTCQB	5,814	17,062	8,796	51.3	(48.4)
Pink	82,380	134,063	100,644	22.2	(24.9)
Number of securities quoted	11,336	12,091	12,725	12.3	5.2
Number of active ATS participants	85	82	83	(2.4)	1.2
Number of ECN subscribers	64	82	84	31.3	2.4
New form 211 filings	71	197	200	181.7	1.5
Revenue per security quoted (\$)	323	850	604	87.0	(29.0)
Corporate Services					
Number of corporate clients (period end)					
OTCQX	415	482	530	27.7	10.0
OTCQB	885	962	1,020	15.3	6.0
Pink	690	789	999	44.8	26.6
Total	1,990	2,233	2,549	28.1	14.2
Revenue per client (\$)	3,303	3,640	3,840	16.3	5.5
Graduates to a national securities exchange	9	29	46	411	59
Market Data Licensing					
Market data professional users	22,533	24,404	25,647	13.8	5.1
Market data non-professional users	16,545	27,814	28,977	75.1	4.2
Revenue per terminal (total - \$)	175	151	157	(10.4)	3.9
Market data compliance file users	44	46	47	6.8	2.2

Source: OTCM, Edison Investment Research

Other developments

OTCM is on track to launch a third alternative trading system (ATS) in Q321 called OTC Link NBQ in addition to OTC Link ATS and OTC Link ECN. The two existing platforms are complementary, with OTC Link ATS providing a network to publish quotes and to facilitate trades between subscribers, while OTC Link ECN operates an anonymous matching engine and acts as an order router, functioning as the execution party on an agency basis.

OTC Link NBQ will provide alternative functionality to broker dealers, enabling electronic matching and execution, but with full disclosure rather than anonymity and allowing distribution of full depth of book data rather than top of book alone, as at OTC Link ECN. Management have stated that it is unable to gauge the financial impact or how successful this new interdealer quotation system (IDQS) will be. However, we believe the launch of NQB will be an attractive proposition to clients and thus should be a positive for OTC Link's revenue in the medium term.

On 16 September 2020, the SEC published a final **Rule 15c2-11**. This has a compliance date of 28 September 2021. Rule 15c2-11 governs information requirements before quotes may be published on interdealer quotation systems such as OTC Link ATS. The amended rule will generally prohibit broker-dealers from submitting or publishing quotations for securities on OTC Link ATS unless current information about the company is publicly available. The rule will permit OTC Link ATS, as a qualified IDQS, to perform the required information review to determine whether a security is

eligible for public quoting. This will enable OTCM to streamline onboarding of securities to its markets, removing the risk and administrative burden of certifying the suitability of securities for quotation from broker dealers, which in turn will allow them to focus on their financial advisory role.

In **December 2020** the SEC published a proposed exemptive order that would, subject to approval, allow OTC Link to operate an Expert Market for companies that do not meet the information requirements allowing sophisticated or professional investors to continue to trade in the securities. **On 2 August 2021**, the SEC's Division of Trading and Markets indicated that the SEC chair did not intend to approve the order in the short term. Accordingly, while the Expert Market for 'no information' securities will continue to operate, the market will only be available for unsolicited quotes representing limit orders from customers not affiliated with the issuer. Expert Market data feeds will continue to be available to broker-dealers and other sophisticated investors.

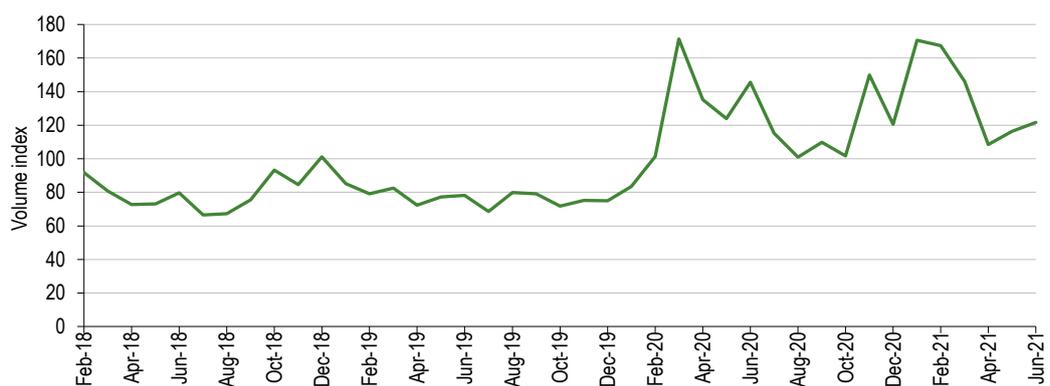
Background and outlook

OTCM has reiterated its three priorities for 2021 as:

1. Implementation of amended Rule 15c2-11, effective 28 September 2021. OTCM sees the amended rule as a significant shift for the group, moving it from being a provider of ATS platforms to being recognised as setting the standard for monitoring the level of disclosure, compliance and governance of OTCM companies.
2. Remaining focused on the reliability of trading systems and enhancing their functionality for traders.
3. Continued support for OTCQX and OTCQB issuers. This will include enabling efficient interaction with shareholders, providing an efficient onboarding process for new clients and maintaining high service levels.

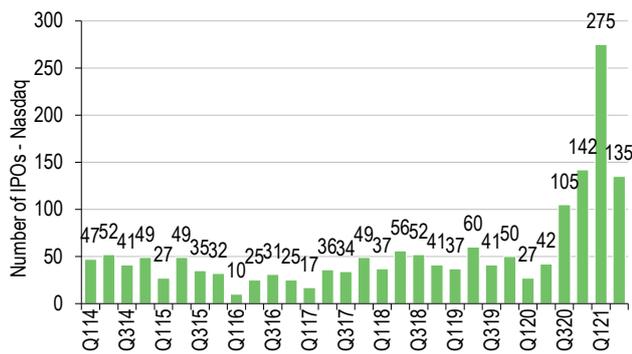
Given the impact of trading activity on recent results, we include in Exhibit 5 an index of the average daily volume of US equity share trading. This shows two spikes in early 2020 and from the end of 2020 to Q121. In line with OTCM's commentary, this appears to have begun to normalise in April 2021.

Exhibit 5: US equity share trading (consolidated monthly average daily volume)

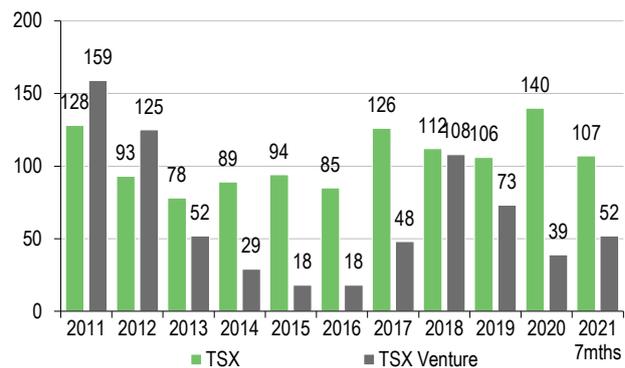


Source: Nasdaq, Edison Investment Research

The trends in the number of IPOs on the Nasdaq, TSX and TSX Venture exchanges are shown in Exhibits 6 and 7. The number of IPOs on Nasdaq has tempered after very strong activity in Q121. TSX IPOs for the first seven months of 2021 were up 27% by number compared with the same period in 2020 and the TSX Venture exchange saw an 174% increase.

Exhibit 6: Nasdaq – number of IPOs


Source: Nasdaq

Exhibit 7: TSX and TSX Venture – number of IPOs


Source: TMX

Looking at the trend in the number of corporate client additions for OTCM shown in Exhibit 2, the Q221 figures reflect the favourable development in IPOs highlighted above. OTCM indicates that this has continued into the current quarter, with a good pipeline of potential clients also in place.

Financials

Headline figures from our revised estimates are shown in Exhibit 8 with further detail, including the divisional breakdown of revenues, shown in the financial summary (Exhibit 10).

Following a strong Q221, our group revenue estimate for 2021 is increased by 7.6%, including a 15% increase in the estimate for OTC Link (strong quarterly performance followed by an assumed normalisation of trading activity, as discussed above). We continue to assume a significant normalisation (-40%) in revenue for the division in 2022. The higher multiple divisions of Market Data Licensing and Corporate Services also beat our expectations by 9% and 15% respectively.

Our revenue growth assumptions for **Market Data Licensing** (16% and -7% for 2021 and 2022) are influenced by our assumption of lower trading levels possibly affecting non-professional subscription levels, particularly in 2022. Uncertainty on this point, together with the outlook for trading activity levels in US equities, should be considered when viewing our estimates. Nevertheless, we increase our estimates by 6% for both 2021 and 2022.

For **Corporate Services**, the strong new client additions have translated into an increase in our estimates (4% for 2021 and 7% 2022), although we do not assume that they continue at the same rate.

OTCM's balance sheet remains strong, with no debt and cash of \$43.0m or \$44.6m including restricted cash at the end of Q221. In addition to cash held, OTCM has an undrawn line of credit of up to \$1.5m available. This indicates that the capital return profile, mainly in the form of dividends, is reasonably secure in the near to mid-term. The group has paid a special dividend since 2014 and this should continue to feature in the group's investment case in the near to medium term.

Exhibit 8: Estimate revisions

	Gross revenue (\$m)			PBT (\$m)			Diluted EPS (\$)			Dividend (\$)		
	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)	Old	New	Change (%)
2021e	85.9	92.5	7.6	28.6	33.1	15.8	1.93	2.16	11.8	1.25	1.34	7.2
2022e	77.7	84.1	8.2	25.6	30.5	19.3	1.73	2.06	19.1	1.35	1.41	4.4

Source: Edison Investment Research. Notes: Dividends include the special dividend of 65c announced for FY20 and estimates of 65c for FY21 and 75c for FY22.

Valuation

An updated version of our comparative P/E table is shown in Exhibit 9 below. This includes information providers MSCI and Markit together with the average multiples for global exchanges. OTCM shares are trading on prospective P/Es below the average for global exchanges for 2021 and 2022 (which also reflects the normalisation of elevated trading volumes). The shares trade on markedly lower P/Es than the those for information providers. While the multiple applied to prospective earnings may be limited by the relative illiquidity of OTCM shares, the group is financially strong and has a high proportion of subscription-based revenues. The positive change in business mix in Q221 suggests a higher multiple rating could be justified going forward.

Exhibit 9: OTCM comparative multiples

	P/E ratios (x)	
	2021e	2022e
MSCI	64.2	57.2
Markit	37.2	33.4
Average information providers	39.8	35.2
Average global exchanges	26.1	24.3
OTCM	21.1	22.1

Source: Refinitiv, Edison Investment Research. Note: Prices as at 10 August 2021.

Exhibit 10: Financial summary

\$000s	2016	2017	2018	2019	2020	2021e	2022e
Year end 31 December							
PROFIT & LOSS							
OTC Link	10,573	10,074	11,175	11,676	15,890	26,464	15,878
Market Data Licensing	21,054	21,922	23,384	24,447	28,133	32,705	30,416
Corporate Services	19,254	22,660	24,719	26,716	27,206	33,298	37,764
Revenue	50,881	54,656	59,278	62,839	71,229	92,467	84,058
Re-distribution fees and rebates	(2,317)	(2,480)	(2,448)	(2,489)	(2,810)	(2,896)	(3,042)
Net revenue	48,564	52,176	56,830	60,350	68,419	89,571	81,017
Transaction-based expenses	0	0	(375)	(746)	(3,022)	(7,971)	(3,334)
Revenues less transaction-based expenses	48,564	52,176	56,455	59,604	65,397	81,600	77,682
Operating expenses	(30,032)	(32,511)	(35,768)	(40,230)	(42,202)	(46,753)	(45,364)
EBITDA	18,532	19,665	20,687	19,374	23,195	34,847	32,319
Depreciation	(1,606)	(1,361)	(1,042)	(1,492)	(1,761)	(1,779)	(1,796)
Operating profit	16,926	18,304	19,645	17,882	21,434	33,068	30,522
Net interest	9	47	116	103	(27)	25	25
Profit Before Tax	16,935	18,351	19,761	17,985	21,407	33,093	30,547
Tax	(6,407)	(5,792)	(3,524)	(3,043)	(3,133)	(7,174)	(5,804)
Profit after tax	10,528	12,559	16,237	14,942	18,274	25,919	24,743
Profit after tax and allocation to RSAs	10,252	12,241	15,840	14,588	17,839	25,484	24,308
Average Number of Shares Outstanding (m)	11.3	11.6	11.6	11.7	11.6	11.8	11.8
EPS - basic (c)	92.4	109.9	140.8	128.4	156.4	222.4	211.6
Fully diluted EPS (c)	90.4	105.8	136.3	124.7	153.4	216.0	205.6
Dividend per share (c)	116.0	116.0	123.0	125.0	125.0	134.0	141.0
EBITDA Margin (%)	38	38	36	32	34	39	40
Operating profit margin (%)	35	35	35	30	31	37	38
BALANCE SHEET							
Non-current assets							
Intangible assets	291	362	312	291	291	291	291
Property and other	3,267	3,506	4,584	25,034	22,414	21,966	20,104
Current assets							
Debtors	6,262	6,450	4,942	5,157	6,609	7,743	7,743
Cash & cash investments	25,034	23,683	28,813	28,217	33,733	47,957	62,237
Other current assets	1,789	2,316	2,998	1,656	1,763	1,879	1,879
Current liabilities							
Deferred revenues	(14,664)	(15,531)	(16,070)	(15,815)	(18,765)	(23,000)	(26,085)
Other current liabilities	(5,372)	(5,644)	(6,711)	(9,574)	(11,232)	(9,984)	(9,984)
Long-term liabilities							
Tax, rent and other	(1,101)	(1,351)	(2,459)	(17,293)	(15,267)	(15,378)	(14,023)
Net assets	15,506	13,791	16,409	17,673	19,546	31,474	42,163
NAV per share (\$)	1.36	1.21	1.42	1.52	1.67	2.67	3.58
CASH FLOW							
Net cash flow from operating activities	15,740	16,483	22,590	21,413	26,013	32,388	32,175
Capital expenditure, intangible investment	(415)	(1,165)	(549)	(5,516)	(1,034)	(850)	(1,300)
Dividends	(13,059)	(13,262)	(14,195)	(14,560)	(14,610)	(15,418)	(16,595)
Purchase of treasury stock	(1,714)	(2,176)	(1,047)	(1,390)	(3,520)	(1,522)	0
Financing / investments	557	(1,231)	(1,669)	(543)	(1,333)	(374)	0
Net cash flow	1,109	(1,351)	5,130	(596)	5,516	14,224	14,280
Opening net (debt)/cash	23,925	25,034	23,683	28,813	28,217	33,733	47,957
Closing net (debt)/cash	25,034	23,683	28,813	28,217	33,733	47,957	62,237
Cash and restricted cash	25,244	24,375	30,534	29,778	35,297	49,521	63,801

Source: OTC Markets Group annual reports, Edison Investment Research

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