

OTC Markets Group

Q321 results

Hitting it out of the ballpark

OTC Markets Group's (OTCM's) Q321 revenues were 20% ahead of our expectations, driven by trading (+22%), Market Data Licensing operations, which we consider to be a high-value business (+6%) and Corporate Services (+32%). Net acquisition of corporate clients has tempered marginally from Q221 but remains elevated, which bodes well despite a likely normalisation in trading activity. We raise our EPS forecast by 8% for 2021 and 14% for 2022. Management's confidence prompted it to maintain the quarterly dividend at \$0.18/share and to announce a special dividend of \$1.50, and we expect the group to pay a similar special dividend in 2022.

Year end	Revenue (\$m)	PBT (\$m)	EPS* (\$)	DPS** (\$)	P/E (x)	Yield (%)
12/19	62.8	18.0	1.25	1.25	47.0	2.1
12/20	71.2	21.4	1.53	1.25	38.4	2.1
12/21e	97.9	35.6	2.33	2.19	25.2	3.7
12/22e	88.5	34.8	2.35	2.22	25.0	3.8

Note: *Fully diluted and calculated after restricted stock award allocation. **Including special dividends of 65c each year for FY19/20 and \$1.50 for FY21e/22e.

Q321 summary: Boosted by Corporate Services

OTCM reported a very strong third quarter, with gross revenues of \$25.2m, up 42% compared with Q320. Segmentally, this was led by OTC Link (+60%), which benefited from elevated US equity trading levels (albeit lower than Q221) and Corporate Services (+57%), with Disclosure and News Service (DNS) product driving the better-than-expected result. Expenses, including redistribution fees and transaction-based expenses, increased by 27%, reflecting volume-related costs and incentive compensation as well as increases in base salaries. This left pre-tax profit up 78% and, after a higher tax charge, diluted EPS increased by 68%.

Trading normalisation, but underlying trends positive

Following Q321, there are further signs that US equity trading activity continues to normalise, and we have assumed this in our forecasts. 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 (561, up 6% quarter-on-quarter and 27% year-on-year) and OTCQB (1,067, up 5% quarter-on-quarter and 22% year-on-year) is likely to have longer-lasting benefits. We have increased our 2021 EPS estimate by 8%, which reflects a normalisation in trading but stronger corporate services revenue following the implementation of the Securities and Exchange Commission's (SEC's) Exchange Act rule 15c2-11, while our 2022 estimate has increased by 14%, reflecting an increase in corporate services revenue forecasts that will also benefit from repricing in January 2022.

Valuation: Remains attractive

Following our estimate changes, the shares trade on a 2022e P/E of 25.0x, marginally above the average for global exchanges of 24.2x (see Exhibit 9). The multiples remain significantly below those of information providers (46.7x). The high proportion of subscription-based revenues and longer-term potential for the development of OTCM's cost-effective markets are supportive factors.

Financial services

24 November 2021

Price **US\$58.75**
Market cap **US\$693m**

Net cash (\$m) at 30 September 2021 50.0

Shares in issue 11.8m

Free float 62.6%

Code OTCM

Primary exchange OTCQX

Secondary exchange N/A

Share price performance



	1m	3m	12m
%			
Abs	16.9	30.6	69.5
Rel (local)	13.3	24.7	29.2

52-week high/low US\$60.00 US\$33.53

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 78% in Q321.

Next events

Q421 results March 2022

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Q321 results analysis

Exhibit 1 provides a summary of profit and loss figures, comparing the Q321 results with Q221 and Q320. In the comments below, we are comparing Q321 with Q320 unless stated.

Gross revenues were up 42% on Q320. While there was a decrease in revenue from OTC Link trading quarter-on-quarter (a FINRA member broker-dealer that operates two Securities and Exchange Commission (SEC) registered Alternative Trading Systems), the Corporate Services division, which in our view is the highest quality and thus implicitly the most highly valued component of OTC's businesses, was up 16% relative to Q221.

Market Data Licensing (distributes market data and financial information) revenue increased by 18%, with the main contributor being the growth in non-professional users as retail participation in equity markets remained elevated. 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 57% was generated by a combination of strong additions in new clients for OTCQX and OTCQB markets (see Exhibit 2), price increases and an increasing number of companies subscribing to the group's DNS product in order to comply with regulation 15c2-11.

Redistribution fees, which relate to market data services, grew by 8% and transaction-based expenses (payments for liquidity provision on OTC Link ECN) were up 172% as a result of higher transaction activities.

Operating expenses (before depreciation and amortisation) were up 21%, 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 78% to \$9.7m, while a higher tax charge of 22.5% versus 18.1% left diluted earnings up 68% at \$0.62 from \$0.37.

Exhibit 1: Profit and loss analysis					
\$000s	Q320	Q221	Q321	% change vs Q320	% change vs Q221
OTC Link	3,816	7,682	6,110	60	(20)
Market Data Licensing	7,172	8,586	8,489	18	(1)
Corporate Services	6,759	9,182	10,621	57	16
Gross revenues	17,747	25,450	25,220	42	(1)
Redistribution fees and rebates	(689)	(746)	(744)	8	(0)
Net revenue	17,058	24,704	24,476	43	(1)
Transaction-based expenses	(614)	(2,487)	(1,668)	172	(33)
Revenues less transaction-based expenses	16,444	22,217	22,808	39	3
Operating expenses (excl. depreciation and amortisation)	(10,525)	(12,633)	(12,686)	21	0
Depreciation and amortisation	(441)	(441)	(446)	1	1
Income from operations	5,478	9,143	9,676	77	6
Other income/net interest	(35)	0	12		
Income before provision for income taxes	5,443	9,143	9,688	78	6
Taxes	(984)	(2,071)	(2,176)	121	5
Net income	4,459	7,072	7,512	68	6
Diluted EPS (\$)	0.37	0.59	0.62	68	6
Operating margin (%)	32.1	37.0	39.5		
Tax rate (%)	18.1	22.7	22.5		

Source: OTCM, Edison Investment Research

Exhibit 2 shows how the corporate client base for the OTCQX and OTCQB markets has evolved from Q319. After a low point in Q120/Q220, the rate of new client additions for both markets improved again in the third quarter year-on-year. In OTCQX they were down slightly quarter-on-quarter from previously elevated levels.

Q321 showed a continuation of the strong momentum with 55 additions for OTCQX (OTC Markets' premium platform market providing efficient public trading without the complexity and cost of a national securities exchange listing) and 115 for OTCQB (a venture market providing public trading for entrepreneurial and development-stage companies and which applies standards that promote price transparency and facilitate public disclosure). OTCQB is also open to international companies, representing 10.4% and 11.3% 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 4.5% (OTCQX) and 6.7% (OTCQB), leaving net additions in the quarter at 31 and 47 companies respectively.

Of the 55 new corporates joining OTCQX, 44 were international issuers and of the 115 joining OTCQB, 90 were international. Management noted increased sales in the UK and Canadian offices, which remain at healthy levels. 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 markets at a lower cost than incumbent exchanges.

Exhibit 2: Evolution of OTCQX and OTCQB corporate client base

	Q319	Q419	Q120	Q220	Q320	Q420	Q121	Q221	Q321
OTCQX									
Start	421	436	442	414	415	441	461	482	530
Additions	31	32	9	19	44	34	52	70	55
Other (cancellations, downgrades)	(16)	(26)	(37)	(18)	(18)	(14)	(31)	(22)	(24)
End	436	442	414	415	441	461	482	530	561
Net change	15	6	(28)	1	26	20	21	48	31
OTCQB									
Start	916	915	907	893	885	874	902	962	1,020
Additions	53	43	28	45	62	94	83	112	115
Other (cancellations, downgrades)	(54)	(51)	(42)	(53)	(73)	(66)	(23)	(54)	(68)
End	915	907	893	885	874	902	962	1020	1067
Net change	(1)	(8)	(14)	(8)	(11)	28	60	58	47

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 Q320 and Q321. The main drivers of the 19.8% increase were higher compensation, and professional and consulting costs (rule 15c2-11), a continuation of the trend in Q221. Compensation and information technology costs remain a significant proportion of overall expenses, representing approximately 80% of total operating expenses (excluding one-offs). 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	Q320	Q321	Absolute change	% change	Comments
Compensation and benefits	7,052	8,471	1,419	20.1	Headcount up 8 to 109, higher cash incentive compensation +58% and regulatory obligations, Rule 15c2-11
IT infrastructure and information services	1,642	2,062	420	25.6	Incremental data centre and network costs to support ECN growth
Professional and consulting fees	586	1,008	422	72.0	Higher ECN clearing/regulatory costs with volume, support costs for VIC business and Rule 15c-11
Marketing and advertising	138	218	80	58.0	Public relations spending and rebound in travel expenses
Occupancy costs	877	521	(356)	(40.6)	Due to a one-time catch-up for certain building costs billed in 2020
Depreciation and amortisation	441	446	5	1.1	IT infrastructure enhancements in 2020 and 2021
General, administration and other	230	406	176	76.5	Higher payment processing fees and bad debt expenses
Total	10,966	13,132	2,166	19.8	

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 a slowdown in trading volumes compared with Q221 but still remaining at elevated levels, which reflects the wider US equity markets generally. For Corporate Services, analysis of the growth in OTCQX and OTCQB client numbers is discussed above (see Exhibit 2). In Market Data Licensing, the growth in non-professional users has slowed but is still reflecting 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

	Q320	Q221	Q321	% change y-o-y	% change q-o-q
OTC Link					
Dollar volume traded (000s)					
OTCQX	17,021	60,030	41,802	145.6	(30.4)
OTCQB	6,942	8,796	5,008	(27.9)	(43.1)
Pink	69,988	100,644	107,295	53.3	6.6
Number of securities quoted	11,381	12,725	11,604	2.0	(8.8)
Number of active ATS participants	82	83	85	3.7	2.4
Number of ECN subscribers	69	84	90	30.4	7.1
New form 211 filings	196	200	151	(23.0)	(24.5)
Revenue per security quoted (\$)	335	604	527	57.0	(12.8)
Corporate Services					
Number of corporate clients (period end)					
OTCQX	441	530	561	27.2	5.8
OTCQB	874	1,020	1,067	22.1	4.6
Pink	722	999	1,556	115.5	55.8
Total	2,037	2,549	3,184	56.3	24.9
Revenue per client (\$)	3,357	3,840	3,705	10.4	(3.5)
Graduates to a national securities exchange	19	46	45	137	(2)
Market Data Licensing					
Market data professional users	22,926	25,647	25,870	12.8	0.9
Market data non-professional users	20,102	28,977	29,156	45.0	0.6
Revenue per terminal (total - \$)	167	157	154	(7.4)	(1.9)
Market data compliance file users	44	47	47	6.8	0.0

Source: OTCM, Edison Investment Research

Other developments

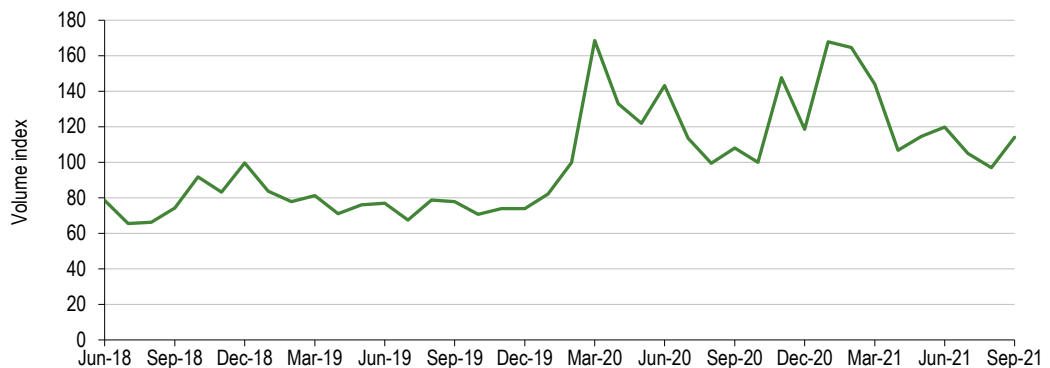
OTCM launched its third alternative trading system (ATS) in Q321 called OTC Link NBQ in addition to OTC Link ATS and OTC Link ECN. The two existing platforms are complementary, with OTC Link ATS providing a network to publish quotes and facilitate trades between subscribers, while OTC Link ECN operates 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. Management has 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 NBQ will be an attractive proposition to clients and thus should be a positive for OTC Link's revenue in the medium term.

Background and outlook

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 return to more normal levels. These trends have been reflected in OTC's trading revenues.

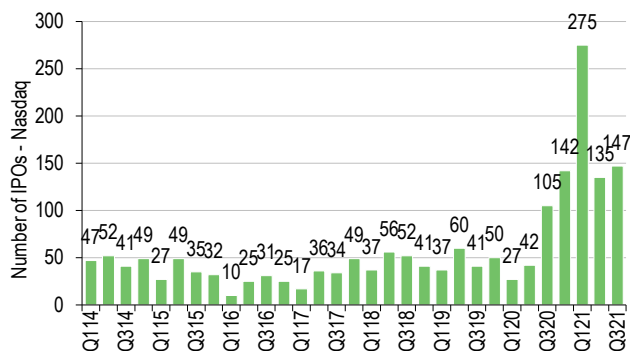
Exhibit 5: US equity share trading (consolidated monthly average daily volume)



Source: Nasdaq, Edison Investment Research

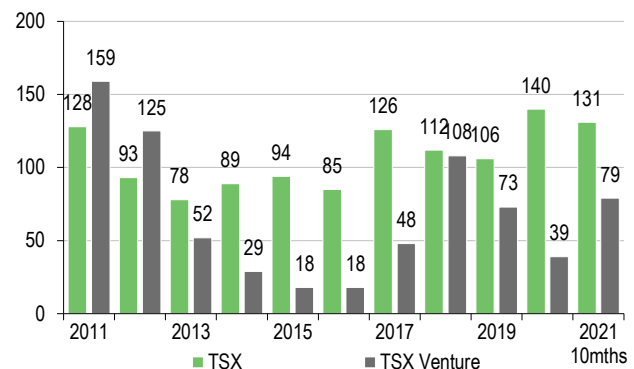
The trends in the number of IPOs on the Nasdaq, TSX and TSX Venture exchanges are shown in Exhibits 6 and 7. The number of IPOs on Nasdaq has tempered after very strong activity in Q121. TSX IPOs for the first 10 months of 2021 were up 5% by number compared with the same period in 2020 and the TSX Venture exchange saw a 147% 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 Q321 figures reflect the favourable development in IPOs highlighted above.

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 Q321, we have increased our group revenue estimate for 2021 by 5.9%. This includes a 10% increase in the estimate for OTC Link (reflecting strong quarterly performance followed by an assumed normalisation in trading activity, as discussed above). We continue to assume a significant normalisation (-40%) in revenue for the division in 2022. The higher multiple value (in our view) divisions of Market Data Licensing and Corporate Services also beat our Q321 expectations by 6% and 32% respectively.

Our revenue growth assumptions for **Market Data Licensing** (19% and -7% for 2021e and 2022e) are influenced by our assumption of lower trading levels possibly affecting non-professional subscription levels, particularly in 2022. Uncertainty on this point, as well as on the outlook for trading activity levels in US equities, is incorporated in our estimates. Nevertheless, we increase our Market Data Licensing revenue estimates by 2.6% for both 2021 and 2022.

For **Corporate Services**, the strong new client additions and strong sales of the DNS product have translated into an increase in our estimates (by 6.0% for 2021e and 5.6% 2022e).

OTCM's balance sheet remains strong, with no debt and cash of \$50.0m or \$51.5m including restricted cash at the end of Q321. 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 we expect this to continue 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	92.5	97.9	5.9	33.1	35.6	7.6	2.16	2.33	7.8	1.34	2.19	63.4
2022e	84.1	88.5	5.3	30.5	34.8	14.1	2.06	2.35	13.9	1.41	2.22	57.4

Source: Edison Investment Research. Notes: Dividends include a quarterly 18c and an additional special dividend of \$1.50 announced with the Q321 results. We expect a similar special dividend for FY22e.

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 in elevated trading volumes). The shares trade on markedly lower P/Es than 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 Q321 suggests a higher multiple rating could be justified going forward.

Exhibit 9: OTCM comparative multiples

	P/E ratios (x)	
	2021e	2022e
MSCI	65.4	57.4
Markit	40.1	36.1
Average information providers	52.8	46.7
Average global exchanges	25.8	24.2
OTCM	25.2	25.0

Source: Refinitiv, Edison Investment Research. Note: Prices as at 24 November 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	29,074	17,444
Market Data Licensing	21,054	21,922	23,384	24,447	28,133	33,548	31,200
Corporate Services	19,254	22,660	24,719	26,716	27,206	35,293	39,893
Revenue	50,881	54,656	59,278	62,839	71,229	97,915	88,537
Redistribution fees and rebates	(2,317)	(2,480)	(2,448)	(2,489)	(2,810)	(2,982)	(3,120)
Net revenue	48,564	52,176	56,830	60,350	68,419	94,932	85,417
Transaction-based expenses	0	0	(375)	(746)	(3,022)	(8,544)	(3,663)
Revenues less transaction-based expenses	48,564	52,176	56,455	59,604	65,397	86,388	81,753
Operating expenses	(30,032)	(32,511)	(35,768)	(40,230)	(42,202)	(49,010)	(45,179)
EBITDA	18,532	19,665	20,687	19,374	23,195	37,379	36,574
Depreciation	(1,606)	(1,361)	(1,042)	(1,492)	(1,761)	(1,777)	(1,795)
Operating profit	16,926	18,304	19,645	17,882	21,434	35,602	34,780
Net interest	9	47	116	103	(27)	27	25
Profit Before Tax	16,935	18,351	19,761	17,985	21,407	35,629	34,805
Tax	(6,407)	(5,792)	(3,524)	(3,043)	(3,133)	(7,714)	(6,613)
Profit after tax	10,528	12,559	16,237	14,942	18,274	27,915	28,192
Profit after tax and allocation to RSAs	10,252	12,241	15,840	14,588	17,839	27,480	27,757
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	239.7	241.5
Fully diluted EPS (c)	90.4	105.8	136.3	124.7	153.4	232.9	234.6
Dividend per share (c)	116.0	116.0	123.0	125.0	125.0	219.0	222.0
EBITDA Margin (%)	38	38	36	32	34	39	43
Operating profit margin (%)	35	35	35	30	31	38	41
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	22,033	20,173
Current assets							
Debtors	6,262	6,450	4,942	5,157	6,609	7,601	7,601
Cash & cash investments	25,034	23,683	28,813	28,217	33,733	41,205	49,298
Other current assets	1,789	2,316	2,998	1,656	1,763	2,344	2,344
Current liabilities							
Deferred revenues	(14,664)	(15,531)	(16,070)	(15,815)	(18,765)	(23,000)	(25,998)
Other current liabilities	(5,372)	(5,644)	(6,711)	(9,574)	(11,232)	(11,572)	(11,572)
Long-term liabilities							
Tax, rent and other	(1,101)	(1,351)	(2,459)	(17,293)	(15,267)	(15,447)	(14,092)
Net assets	15,506	13,791	16,409	17,673	19,546	23,454	28,044
NAV per share (\$)	1.36	1.21	1.42	1.52	1.67	1.99	2.38
CASH FLOW							
Net cash flow from operating activities	15,740	16,483	22,590	21,413	26,013	36,329	35,534
Capital expenditure, intangible investment	(415)	(1,165)	(549)	(5,516)	(1,034)	(1,446)	(1,300)
Dividends	(13,059)	(13,262)	(14,195)	(14,560)	(14,610)	(25,434)	(26,142)
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)	(455)	0
Net cash flow	1,109	(1,351)	5,130	(596)	5,516	7,472	8,093
Opening net (debt)/cash	23,925	25,034	23,683	28,813	28,217	33,733	41,205
Closing net (debt)/cash	25,034	23,683	28,813	28,217	33,733	41,205	49,298
Cash and restricted cash	25,244	24,375	30,534	29,778	35,297	42,769	50,862

Source: OTC Markets Group annual reports, Edison Investment Research

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