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OTCM - Q4 2017 OTC Markets Group Inc Earnings Call

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PRESENTATION

Operator

Greetings, and welcome to the OTC Markets Group Fourth Quarter and Year-End 2017 Earnings Release Conference Call. (Operator Instructions)
As a reminder, this conference is being recorded.

I'd now like to turn the conference over to Dan Zinn. Please go ahead, Dan.

Daniel Zinn - *OTC Markets Group Inc - General Counsel & Corporate Secretary*

Thank you, operator. Good morning, and welcome to the OTC Markets Group Fourth Quarter and Year-End 2017 Conference Call. With me today are Cromwell Coulson, our President and Chief Executive Officer; and Bea Ordonez, our Chief Financial Officer.

This is our first earnings call to be (inaudible) via live webcast presentation. Our earnings press release and the presentation are each available on our website.

Certain statements during this call and in our presentation may relate to future events or expectations and as such, may constitute forward-looking statements. Actual results may differ materially from these forward-looking statements. Information concerning risks and uncertainties that may impact our actual results is contained in the Risk Factors section of our 2017 annual report, which is available on our website. For more information, please refer to the safe harbor statement on Slide 3 of our presentation.

With that, I will turn the call over to Cromwell Coulson.

Robert Cromwell Coulson - *OTC Markets Group Inc - CEO, President & Director*

Thank you, Dan. Good morning, and thank you, everyone, for joining the call. I'm going to talk about the key initiatives we worked towards in 2017, including important milestones and factors that will shape our strategy going forward. We continue to be guided by our mission and our strategy. Our mission is to create better-informed and more efficient financial markets. We fulfill that mission by executing our strategy, which is operating world-leading securities markets. We share information widely through open networks that foster greater transparency. We connect broker-dealers, organize markets and inform investors. We deliver elegant, reliable and cost-effective subscription-based solutions for a future that is online, data-driven and social. Our mission, strategy and company values provide us with the roadmap as we focus on initiatives that will improve our technology platform and data-driven products provide value to our clients, create growth opportunities for our colleagues and continue to deliver long-term value for our company's shareholders.

We were pleased to report 7% top line revenue growth in 2017, representing another year of record revenues and operating income. Bea will cover our results in more detail in a few moments. Our overall results reflect the combined effort of our entire team and exemplify our 3 business lines



generally work in concert. Broker-dealers use our technology-driven platform to quote and trade over 10,000 securities. Our Market Data Licensing business distributes market data to broker-dealers, investors and other market participants through an interconnected network of market data distributors. Our Corporate Services business operates the OTCQX and OTCQB premium markets and offers issuers disclosures and regulatory compliance products. Regulatory recognition for our markets and supporting small company capital formation were top priorities in 2017 and remain a primary focus in 2018. Since our last call, we added Tennessee and Louisiana to our Blue Sky map. That means the companies on our OTCQX market now qualify for secondary trading exemptions in 29 states. Michigan and Oklahoma have each publicly announced a rule proposal recognizing our OTCQX and OTCQB markets as well, which continues to move us towards our goal of national Blue Sky recognition for the OTCQX market.

As I've noted before, our OTCQX and OTCQB markets were recognized as established public markets by the SEC in 2013, and with each new state and each new regulatory recognition, we enhance our reputation for offering efficient public markets that work for companies, investors and brokers. We hope our recent accomplishments will lead to attaining other national-level regulatory recognitions in 2018.

We achieved a number of milestones in-house last year as well. Within our Corporate Services business line, towards the end of the year we announced 2 strategic alliances: one with the Canadian Securities Exchange; and another with Issuer Direct Corporation. Working with the CSE will allow us to be part of a North American capital and visibility solution for companies looking to gain cost-effective access to U.S. investors on our OTCQX or OTCQB markets. The CSE deal is nonexclusive and builds on what we've done for other global companies listed on leading international stock exchanges. Our initiative with the Issuer Direct has already launched, and we now offer our company's cost-effective easy access to a suite of news, communications, compliance and investor relations services. We hope the Issuer Direct relationship will help lower the cost and burden of being a public company.

In November, we announced a new policy on stock promotion, which establishes company best practices and drives enhanced market transparency. Fraudulent stock promotion is an industry-wide concern, and our policy codifies the core principles of our disclosure-based philosophy. In our OTC Link business, we were excited to launch the new OTC Link ECN. OTC Link ECN offers an anonymous matching engine and liquidity radar, expanding the choices available to our broker-dealer subscribers. OTC Link ECN is still in its infancy, and we look forward to working with our subscriber base to grow this platform and add connectivity.

Even as we celebrate new accomplishments and continue to find new solutions for our subscribers, we remain focused on reliability. We continued our record of 100% uptime of our core OTC Link ATS systems during trading hours in 2017. We call out this achievement every quarter because it exemplifies the ongoing commitment of our team at OTC Markets. This focus in keeping with our status of the operator of 2 ATS', including our OTC Link ATS that is covered by the SEC's Regulation SCI.

On a personal note, I want to take a moment to acknowledge that as noted in our annual report, this past December, I sold shares in our company for the first time since 2012. The sale was for 110,000 shares done privately to an institutional investor. It was to fund the purchase of my neighbor's co-op apartment of my primary residence. I'm not going anywhere, if you're worried. I think it goes without saying that I remain 100% committed to this company and our mission and in fine health and look forward to leading this organization for many years to come.

Finally, I'm pleased to announce that yesterday, our Board of Directors declared a quarterly dividend of \$0.14 per share, payable later this month. The announcement of our 37th consecutive quarterly dividend reflects our ongoing commitment to providing superior shareholder returns.

With that, I'll turn the call over to Bea.

Beatrice Ordonez - OTC Markets Group Inc - CFO

Thank you, Cromwell. As we close out our reporting for 2017, I want to take a moment to extend my thanks to everyone on the finance and legal teams for all of their hard work over the last several weeks.

I will now spend a few minutes reviewing our results for the fourth quarter and year ended December 31, 2017. Any reference made to prior period comparatives refers to the fourth quarter of 2016 or the full year 2016 as appropriate.



I will start on Slide 7 of the earnings deck. For the fourth quarter, OTC Markets Group generated \$13.9 million in gross revenues, up 8% versus the prior period. Corporate Services revenues were up 17%. Strong sales combined with reduced churn contributed to a 19% increase in quarter-over-quarter revenues from our OTCQB market. Meanwhile, price increases effective in January 2017 contributed to an 18% increase in OTCQX revenues. The impact of those price increases was partially offset by an increase in Compliance downgrades, which was related to the enhanced OTCQX standards that we introduced in 2017. Market Data Licensing revenues were \$5.4 million, up 4% for the quarter. New sales of our Compliance products combined with quarter-over-quarter increases in reported professional and nonprofessional subscribers were the main contributors. OTC Link generated revenues of \$2.6 million for the quarter, down 3%. This decrease resulted from declines in the number of active market participants and was partially offset by an increase in revenues from trade messages.

Moving now to the full year results. We generated gross revenues of \$54.7 million, an increase of 7% over the prior year. Again, Corporate Services revenues were up 18%. Strong sales and reduced churn on our OTCQB market drove a 16% increase in related revenues. We added 249 new companies to the OTCQB market in 2017, a 10% increase in new sales over the prior year. There were a total of 272 removals from the OTCQB market during 2017, which represented a 23% decrease versus the prior year. This trend reflects the OTCQB market reaching a more mature stage in its development, and we would expect it to continue.

In October 2017, we announced that the service periods beginning on or after January 1, 2018, the annual fee for OTCQB companies will increase from \$10,000 to \$12,000 a year.

Revenues for our OTCQX market increased 19% over the prior year. Price increases effective for the 2017 subscription period drove much of that increase. New sales for the year were up 38% with 83 companies joining the market in 2017. The impact of these price increases and improved sales was partially offset by an increase in the number of downgrades related to noncompliance with our market standards. We saw 91 compliance-related downgrades during 2017 versus 42 such downgrades in the prior year.

For the OTCQX market, renewals are handled annually on a calendar-year basis. In respect of the 2018 annual subscription period, 30 companies elected not to renew. This resulted in a retention rate for the 2018 calendar year of 91% versus the 93% we achieved for 2017.

Market Data Licensing delivered revenues of \$21.9 million, up 4%. A mixture of price increases and new sales of certain data license products, primarily our compliance data products, drove much of that increase. These increases were partially offset by modest year-over-year declines in the number of professional users. On a year-over-year basis, we saw 1.2% decline in the number of professional users. Conversely, we saw a 15% increase in the number of nonprofessional users. This is in line with the more general trend of increased retail participation in the U.S. equities markets. It also reflects continued progress made in expanding our market data redistributor network.

Revenues of \$10.1 million for OTC Link were down 5% versus the prior year. This drop was primarily related to continued, although slower contraction in the number of active participants on our markets. In 2016, we saw the loss of 14 subscribers, including the loss of 1 significant subscriber and added 2 new subscribers. In 2017, we lost 14 active market participants and added 4.

As discussed earlier in the call, in December 2017, we launched our OTC Link ECN. We believe the services offered by our ECN are complementary to our existing offering and will provide a value-add to existing subscribers while also attracting new subscribers. To date, we have added 4 new subscribers to the OTC Link ECN while also enabling a number of our existing subscribers.

Turning now to Slide 8. During the fourth quarter, operating expenses increased 12%. The primary driver was a 15% increase in our compensation costs. Increase in headcount, annual salary raises and increase in 2017 cash bonuses accrued and higher sales commissions in line with increased sales all contributed. One-time severance cost in the fourth quarter amounted to some \$130,000.

Year-over-year operating expenses of \$33.9 million were up 7%, with increases in compensation costs, again, being the primary driver. Our information technology and infrastructure cost for the year increased by 8% with increased expenditure on enhanced security software and other information services being the primary driver.



Turning now to Slide 9. For the fourth quarter, income from operations is \$4.7 million, up 1% versus the prior period, while on a full-year basis, we delivered operating income of \$18.3 million, up 8%. Net income for the quarter increased 8% in line with the 1% uptick in operating income combined with the drop in the company's effective tax rate from 42% in Q4 2016 to 37% in the current quarter, more on that shortly. On a full-year basis, net income increased 19% to \$12.6 million, a result of the 8% increase in operating income and a decrease in the company's effective tax rate for the year from 38% in 2016 to 33% in the current year. The company's effective tax rate decreased primarily as a result of its adoption of accounting guidance related to stock-based compensation. This decrease was offset during the fourth quarter by \$378,000 of tax expense booked in connection with a write-down of the company's deferred tax asset, which followed the enactment in December 2017 of corporate tax reform legislation. On a prospective basis, we would expect our effective tax rate to be in the range of 22% to 24%, and against this backdrop, the company awarded all employees a 3% increase in their base salaries effective January 1, 2018.

In addition to certain GAAP and other measures, management utilizes a non-GAAP measure, adjusted EBITDA, which excludes noncash stock-based compensation expenses. Adjusted EBITDA remained flat at \$5.4 million for the quarter. Adjusted diluted earnings per share decreased slightly to \$0.45 from \$0.46 per share for the prior period. For the full year, our adjusted EBITDA was \$21.6 million or \$1.82 per adjusted diluted share, up 5%. You can find a reconciliation of our GAAP to non-GAAP results in our press release, which is available on our website as well as in the appendix to the earnings presentation.

Moving now to Slide 10. We continue to produce solid operating cash flows. Cash flows from operating activities for the full year amounted to \$16.5 million, a 5% increase over the prior year, a result of the year-over-year increase in net income partially offset by changes in working capital. Free cash flow for the year were flat versus 2016 at \$15.3 million, with the increase in operating cash flows offset by an increase in capital expenditures in the year. During 2017, capital expenditures amounted to \$1.2 million, up \$800,000 versus the prior year. Some \$440,000 of CapEx related to the replatforming of over otcmarkets.com website, while \$100,000 of CapEx related to the launch of the OTC Link ECN.

We ended the year with \$24 million of cash on hand, have a strong balance sheet with no debt and benefit from a subscription base recurring revenue model, which produces consistent and predictable cash flows.

We continue to operate an investor focused capital allocation policy, which returns cash to investors in the form of dividends and through our stock buyback program. During 2017, we returned a total of \$15.4 million, up from \$14.8 million in 2016. We will continue to strategically and prudently utilize our operating cash flows to invest in the people and technologies that will allow us to enhance our product suite, grow our subscriber base and better serve our clients.

In closing, our results for 2017 demonstrate the resilience of our business model and our ability to generate consistent earnings, while investing in new products and technologies and providing strong returns for our shareholders.

With that, I would like to thank everyone for their time, and pass it back to the operator to open up the line for questions.

QUESTIONS AND ANSWERS

Operator

(Operator Instructions) Our first question comes from the line of Chris McGinnis with Sidoti & Company.

Christopher Paul McGinnis - Sidoti & Company, LLC - Special Situations Equity Analyst

I guess just maybe to start out, just on the Blue Sky and maybe can you comment on where you think you -- how strong you can -- in 2018, how -- maybe how far you can get along in 2018 in adding more companies or more states?



Daniel Zinn - *OTC Markets Group Inc - General Counsel & Corporate Secretary*

Yes. Chris, I think it's slow and steady progress at this point. We've had a lot of movement over the past 12 or 18 months. It's nice to see continued action there with states proposing rules. I think our push is to get this to every state that has a manual exemption and then expand it a little bit beyond that to states that will recognize our markets independently. And so we're focusing on both of those simultaneously. So I think you'll continue to see a few states added in each of these earnings calls throughout the year.

Christopher Paul McGinnis - *Sidoti & Company, LLC - Special Situations Equity Analyst*

Okay. And is there any new services you're expecting to add over 2018? I know 2017, there was a number of services. Just wondering about the outlook to help drive revenue growth.

Robert Cromwell Coulson - *OTC Markets Group Inc - CEO, President & Director*

Yes, Chris, this is Cromwell. We announce things when we announce things. We -- and we're much more a place that tries to do things, and if it gets a hook, then we'll talk about them when the revenues actually show up rather than talking about some great-pie-in-the-sky future plans that may or may not work.

Christopher Paul McGinnis - *Sidoti & Company, LLC - Special Situations Equity Analyst*

Okay. Then...

Robert Cromwell Coulson - *OTC Markets Group Inc - CEO, President & Director*

We like to keep those discussions internally and with our clients.

Christopher Paul McGinnis - *Sidoti & Company, LLC - Special Situations Equity Analyst*

Okay. And then secondly, or last question, just on the operating cost. Outside of the expectation of that 3% increase that you talked about on the salaries, do you expect to get some leverage in 2018 versus kind of a little bit of that growth that you invested in 2017?

Beatrice Ordonez - *OTC Markets Group Inc - CFO*

Look, we're obviously going to plan accordingly to where we see the opportunity in the market. So certainly where we see opportunity to grow organically, we will continue to do what we've always done and invest in primarily, the people, but also the technologies that we need to deliver on that growth. We talk about our RSCI and regulatory obligations to the extent that we continue to invest in infrastructure that brings us to a better place in terms of security, reliability, scalability of our systems, we'll continue to do that. Also, because we're in it for the long-term, and we think those investments are appropriate. So we'll continue to do really what we've always done in terms of those investments, which is to just analyzing strategically for where we see the return and allocate resources accordingly.

Robert Cromwell Coulson - *OTC Markets Group Inc - CEO, President & Director*

Yes. We'd actually like to get a little better, take what we've done and do it a little better. So it is our -- and as you look at it is one addition we did have to the management team was a CTO, so we should hopefully become better at -- with our technology assets. And -- but it's not inefficiency or cost-cutting type viewpoint. It's a productivity look. It's like how can we do more with what we have. And it is -- and that's going to be really important because if we're going to continue to do deliver value with our existing products and find new products to solve problem for clients with -- we're going to need to have a strong management layer helping everyone at OTC Markets deliver great products going forward.

Operator

(Operator Instructions) The next question is from the line of Andrew Mitchell with Edison investment Research.

Andrew Mitchell - *Edison Investment Research Limited - Associate Director*

First one I had was just a bit more on the expenses and CapEx spending. Just on the expenses, so I can't sort of without going through all the individual items, but there is a number of items which presumably won't recur in the current year, but obviously, you'll be carrying on investing. I was just wondering from -- in terms of thinking about the expenses, is there any reason not to subtract some of the costs that are sort of more of a one-off nature from the expense line? And then, as you highlighted, quite a -- an increase in the CapEx. Thinking about the cash flow side of things now, what's the thinking in terms of the CapEx going forward?

Beatrice Ordonez - *OTC Markets Group Inc - CFO*

Sure. In terms of the CapEx, as I noted during the call, absolutely, there was some one-time build costs in that CapEx line, which if you sort of take them to the side, obviously, it takes some maintenance CapEx to roughly run rate for the last couple of years. Look, like any company, we'll see little spikes of assets are retired, as we do stuff in data centers in a big way and so on. So it's never going to be a completely linear sort of relationship year-over-year. But there were certainly some one-time items that I highlighted, the website replatforming and the ECN. But look, again, in terms of new products and new services, we're always looking to enhance our offerings and move forward. We just launched the ECN in December. We'll be looking to refine that offering and really getting traction in 2018. And to the extent that, that requires some investment, we'll make it. So yes, it's fair to say that if you look at that CapEx to 2017, there is a couple of large big-ticket one-time items.

Andrew Mitchell - *Edison Investment Research Limited - Associate Director*

And so switching that back to the P&L, which you've already covered to some extent. Is there anything there noticeable, which is a little step-up or a step-down?

Beatrice Ordonez - *OTC Markets Group Inc - CFO*

In terms of one-time items, no, not really. I mean, I noted the severance, there is a couple of sort of smaller items in there as well. But there's not a large amount of sort of one-time expenses. We noted -- you'll find more detail in our MD&A in the annual around some of the one-time -- I won't call them one-time, but slightly -- the slight uptick in regulatory and legal costs related to the launch of our ECN and other initiatives. But overall, I wouldn't characterize the expenses as being one-time type expenses in 2017.

Robert Cromwell Coulson - *OTC Markets Group Inc - CEO, President & Director*

And Andrew, this is Cromwell. As I've looked at in the past, there is things that we might have characterized as one-time, but the next year, some other onetime shows up. And that's kind of the constant of your -- you're fueling organic growth with hopefully small pieces of kindling in the beginning, and then when you see some flames, you throw a bigger log on it. And that's -- so and then there's just some things like it may look like a one-time expense to paint your house, but 10 years come by -- go by, there's another one-time that comes along. So those are -- and as we look at the businesses, we're investing in kind of lights on taking care of the business that's rather constant. We're also going to be doing various foundational work that rotates through. And then we're going to be doing expansions of the platform. So it's a little bit -- we're not in the mode of going, let's chop every cost out of this business and really stop adding services for the clients. I want to be clear with that. That's not our -- our goal is to keep investing in the platform and keep investing in our people to grow the value of our offering for our clients.

Andrew Mitchell - Edison Investment Research Limited - Associate Director

So just one or two last quick questions, please. A relatively small item the restricted cash. Just wondering how that like I could see there was note saying what it is, but was wondering how that arises? And then the other one was, whether there's been a change, it don't appear to be the case, but any change in the competitive horizons as far as OTC Link is concerned?

Beatrice Ordonez - OTC Markets Group Inc - CFO

I'll take the first one. In terms of the restricted cash, in the context of our OTC Link ECN, we became, for the first time, an intermediary to the trading matched on that platform. And so we established an incidence for a clearing agreement with a clearing organization. And as is very common with those kind of arrangements, we maintain margin to support that clearing agreement. Basically, a deposit as another way of saying it, so the duration of that clearing agreement and for some period after any termination. So that's the amount of the deposit that we keep to support our clearing arrangements, and it's characterized as restricted cash.

Andrew Mitchell - Edison Investment Research Limited - Associate Director

And with that step-up in, in line with -- excuse me, steps up in line with the success of the ECN?

Beatrice Ordonez - OTC Markets Group Inc - CFO

Not necessarily, but possibly. Look, the agreement is long. And in terms of their ability to call for margin from anyone who clears with them including us, they have a certain amount of flexibility to call for additional margin. But no, I wouldn't sit there and say it's \$500,000 now, and you just started, it will be \$10 million later. It doesn't tend to ramp up that much. And without getting too in the weeds on the detail, the nature of our business and the kind of clearing that we do and the limited credit exposure that there is related to that business for us and for our clearing broker, given all of those factors, I would not expect there to be a rapid or any necessarily ramp up in the amount of that deposit.

Robert Cromwell Coulson - OTC Markets Group Inc - CEO, President & Director

And -- so to answer about our -- the competitive position of our entity [level] quotation system, we're very lucky to be able to serve the clients we have. And we work very hard to serve them well. Now is -- that is a business though that there's always going to be others looking to take because we have fantastic clients that provide great liquidity and execution services. We believe our platform is rather unique because unlike traditional exchange operators who want brokers to give all their business to the exchanges, our technology is about helping broker-dealers do more trades on their systems. And that is a very common theme of successful technology companies. It is not a common theme how exchange operators work. So we're deeply integrated with their systems, and we're deeply built on success of our clients. And so there will always be competitive threats. The ECN is good because we're giving -- expanding the execution strategy choices for our clients in a cost-effective manner and in a way that interacts well, with the 800-pound gorilla of trading in this space, which is trades taking place on market maker's platforms. And that's really important is that as long as we serve our clients well and keep that focus of making them successful, we will be fine. So -- but there will always be existing and new threats that come into our space and keep us on our toes, so we are sharp and humble at serving our clients.

Operator

(Operator Instructions) Thank you. At this time, I'll turn the floor back to management for closing remarks.



Robert Cromwell Coulson - *OTC Markets Group Inc - CEO, President & Director*

Great. Thank you, everyone, for calling into our annual earnings call. And if you did not get a chance to view our slides live or read our annual report, which has a lot of information, please go to our website, otcmarkets.com, and read both of them, so you understand the opportunities that we face and the challenges that we will address. Thank you, again.

Operator

This concludes today's conference. You may disconnect your lines at this time. Thank you for your participation.

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