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OTCM - Q1 2019 OTC Markets Group Inc Earnings Call

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PRESENTATION

Operator

Greetings, and welcome to OTC Markets Group First Quarter 2019 Earnings Release and Conference Call. (Operator Instructions) As a reminder, this conference is being recorded.

I would now like to turn the conference over to your host, Mr. Dan Zinn, General Counsel. You may begin.

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

Thank you, operator. Good morning, and welcome to the OTC Markets Group first quarter 2019 earnings conference call. With me today are Cromwell Coulson, our President and Chief Executive Officer; and Bea Ordonez, our Chief Financial Officer.

Today's call will be accompanied by a slide 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 2018 Annual Report, which is also available on our website. For more information, please refer to the safe harbor statement on Slide 3 of the earnings presentation.

With that, I'd like to 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 am thrilled to be speaking to you from our new corporate headquarters at 3300 Vesey Street in the heart of Manhattan's financial center. Our state-of-the-art facilities allow us to expand our capabilities and better serve the needs of our clients. It is a space that is already increasing employee satisfaction and team communication, completing the move efficiently on a tight schedule and ensuring that we maximize our resources and minimize business disruption, with a company-wide goal for the first quarter. Everyone involved was up to the challenge. Our new corporate home provides a fresh energy and excitement for executing our mission and strategy over the next decade.

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 who 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 continue to focus us on the initiatives that improve our technology platform and data-driven products, provide value to our clients, create growth opportunities for our colleagues and deliver long-term results for our company's shareholders.

The first quarter was consistent with our commitment to investing in the long-term success of our company and our shareholders. Moving our headquarters was the most visible of these investments, but we also demonstrated our continued commitment to retaining talent and scaling our growth through targeted additions to staff.

We saw a top line revenue growth of 7% during the quarter with operating income down 12% due, in large part, to the impact of move-related expenses. Bea will cover our results in greater detail in a few minutes.

On our last call, we shared the news of our acquisitions of Qaravan Inc. and the Virtual Investor Conferences businesses. During the first quarter, we focused on the hard work of integrating these businesses into our market data and corporate services business line.

With Qaravan, our market data business can provide banking data on over 5,000 public and private banks, including the large contingent of community banks that trade on our markets. Qaravan and similar homegrown offerings provide practical, cost-effective solutions that support financial transparency, performance benchmarking and regulatory compliance for the banking industry.

The Virtual Investor Conferences platform allows investors to interact with company executives through live webcast presentations. The VIC business provides our issuer community with online tools to expand and dynamically communicate with investors. We've hosted 4 events since the acquisition. There are several more events already confirmed for later this year, and we expect our team to continue improving the business throughout the year.

Achieving regulatory recognitions for our OTCQX and OTCQB markets and supporting small company capital formation remains a top priority. Our Blue Sky initiative did not add any additional states during the quarter. However, North Dakota publicly announced an exemption that should be effective this fall. We look forward to adding even more states to the 34 currently on our Blue Sky map and see NASAA take action on the proposed model rule recognizing our markets.

We had 12 companies graduate from our markets to a national securities exchange list in this quarter, continuing our position as the world's most successful venture market.

During the first quarter, we launched Canari, our new web-based interface providing a comprehensive view of quantitative compliance data. Canari allows our award-winning compliance data for OTC and exchange listed securities to reach more broker-dealers, investment managers and compliance professionals, helping them whitelist companies that are demonstrating regulatory compliance and better address market-wide challenges.

Through our suite of compliance data products and other initiatives, we are taking the lead on bringing market participants together to discuss the regulatory initiatives that impact our broader markets. Our underlying goal, and that of the entire industry, is to better inform investors and allow firms to properly assess risk and respond accordingly.

On the trading services front, OTC Link ECN now has 43 subscribers. We will continue to work with our broker-dealer community to optimize their experience across each of our platforms.

As the operator of 2 ATSs, one which is subject to the SEC's Regulation SCI, we remain vigilant about the reliability of our systems and continue to invest in both personnel and infrastructure to accomplish our mission.

We recorded another quarter of 100% up-time of our core OTC Link ATS systems during regular market hours. This achievement reflects our commitment to make system reliability and regulatory compliance a core focus every day at OTC Markets Group.



Finally, I'm pleased to announce that on May 7, our Board of Directors declared a quarterly dividend of \$0.15 per share payable in June. These dividends reflect our ongoing commitment to provide shareholder returns over the long term.

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

Beatrice Ordonez - *OTC Markets Group Inc. - CFO*

Thank you, Cromwell, and thank you all for joining the call. I will now spend a few minutes reviewing our results for the first quarter of 2019. Any reference made to prior period comparatives refers to the first quarter of 2018.

I'll start on Slide 7. For the first quarter of 2019, OTC Markets Group generated \$15.4 million in gross revenues, up 7% with all 3 of our business lines delivering quarter-over-quarter growth. Our Corporate Services business generated revenues of \$6.5 million, up 10%. Revenues from our OTCQX market were up 18%, in line with the higher number of companies on the market.

Strong sales in 2018 and in the current quarter, together with an increase in our annual renewal rate from 91% for 2018 to 94% for 2019, contributed to an increase in the number of companies on the market from 358 companies as of the prior period end to 414 companies as of March 31, 2019.

The number of companies on our OTCQB market has trended down slightly, with 941 companies on the market as of March 31, 2019, versus 951 companies as of the prior period end. Sales have remained flat versus the strong performance we saw in 2018. Our nonrenewal rate has ticked up in the current quarter from 6% to 8%, and compliance-related downgrades have also seen small period-over-period increases. Notwithstanding the slight contraction in the number of OTCQB companies, the full period impact of price increases introduced for 2018 drove a 12% increase in related revenues.

Market Data Licensing revenues were \$6.1 million for the quarter, up 4%. We saw a 7% increase in revenue from professional users, consistent with increase in -- increases in reported users across many of our major redistributed channels. While new sales of our data file products, particularly our suite of compliance products, drove a 20% increase in related revenues.

Following our acquisition of Qaravan in February, during the first quarter, we focused our efforts on integrating Qaravan's technology and suites of products, on implementing an effective outbound sales process and on developing a strong pipeline within the private and public banking sector. OTC Link generated revenues of \$2.8 million, up 7%. Revenues from our OTC Link ECN offset a 9% drop in revenue from messages on OTC Link ATS. This drop is in line with the declining U.S. equity volumes generally when compared to the very active market environment that existed in the first quarter of 2018.

Turning now to Slide 8. During the first quarter, operating expenses increased to 15% to \$10.6 million, while on a normalized basis, excluding onetime expenses incurred related to our office move, expenses increased by 10% to \$10.1 million. The primary driver of the increase in our expense base was a 13% increase in our compensation costs, a result of headcount increases and the impact of salary raises.

Our headcount has increased from 91 as of March 31, 2018, to 98 as of March of 31, 2019. The increase has included first quarter hires made pursuant to our acquisitions of the Qaravan and Virtual Investor Conferences business as well as hires in London and New York to expand our international sales efforts and to grow our trading services business.

Annual salary increases awarded drove a roughly 6% increase in our base salary expense. We continue to operate in a competitive hiring environment, especially in respect of technology talent. In this context, we carefully evaluate our overall compensation structure against top years to ensure that we remain competitive as well as to reward and incentivize performance.

Our IT cost increased 13%, consistent with increased technology support cost related to our recent acquisitions as well as an increase in spend related to system security and reliability initiatives.



Finally, in terms of our discussion of expenses, and as already noted by Cromwell, in late March, we completed our move to new offices in downtown New York. During the first quarter, we had continuing rent obligations at our old space and incurred expenses associated with our move amounting to some \$467,000. On a go-forward normalized basis, we will incur incremental cost related to our new space, excluding depreciation charges of roughly \$150,000 to \$180,000 per quarter.

Moving now to Slide 9. For the first quarter on a GAAP basis, income from operations was \$4 million, down 12%, while net income for the quarter was \$3.5 million, down 5%.

The company's effective tax rate decreased from 18% to 13% with the impact of certain tax credits introduced for 2018 related to foreign-derived income and a higher tax benefit from stock-based compensation driving much of that decrease. On a normalized basis, that is excluding the nonrecurring cost already discussed, net income for the quarter was \$4 million, up 7% versus the prior year period.

Moving now to Slide 10. Cash flows from operating activities for the first quarter amounted to \$481,000, a decrease of \$1.4 million over the prior period. The decrease in net income, including the impact of onetime costs as well as changes in working capital drove that decrease.

During the first quarter, we used operating cash flows as well as cash on hand to fund leasehold and IT infrastructure investments at our new corporate headquarters as well as the necessary upgrades to our data centers. The total spend amounted to \$2.9 million.

We ended the quarter with \$22 million of cash on hand, a strong balance sheet with no debt and benefit from a subscription-based revenue model, which generates predictable recurring cash flows.

We continue to operate an investor-focused capital allocation policy, which returns cash in the form of dividends and through stock buybacks. During the first quarter, we returned a total of \$3.1 million, up 18%. We were pleased to announce our 42nd consecutive quarterly dividend.

In closing, in the first quarter, we made some significant investments in the people needed to drive innovation, grow sales and better serve our subscriber base; in technology-enabled businesses that are additive to our suite of products and can deliver future revenue growth; and in the facilities and infrastructure that will allow us to continue to deliver reliable, cost-effective technology solutions. We remain committed and focused on delivering sustainable, long-term earnings growth and on building upon our track record of 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 Christopher McGinnis with Sidoti & Company.

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

Like just -- maybe just to start on the exposure to the volume. I know a lot of the revenue now is subscription-based, but how much of exposure to volume do you have on your -- on the revenue? And how much maybe was the impact on ECN and the growth rates you've seen recently, last couple of quarters with that?

Beatrice Ordonez - OTC Markets Group Inc. - CFO

Chris, thank you for your question. We call out the trading volume trends and equity volumes, generally, because, obviously, we operate in that equities market landscape and we provide context through that. But as you know, a majority of our revenue stream is subscription-based in nature

and so not particularly subject to that sort of volume and volatility. Where we see little ebbs and flows is in the amount of message traffic and that's why we called it out in the first quarter that we saw that dip when compared to that first quarter in 2018, which is, you recall, was a very active and very volatile market environment. So with that volatility, many of us subscribers see more opportunity. They're more active in the market. And as a result, to the extent that we have revenue streams that are a little bit more volume-dependent, we see ebbs and flows there. But as you say, more than 80% of our revenue stream is subscription-based in nature and, therefore, not really subject to that kind of exposure to market volumes.

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

Appreciate that. And then just maybe some commentary around the uptick in noncompliance, but also renewal. I know that it wasn't significant, but is there any trend now that you see that different versus the prior year?

Beatrice Ordonez - *OTC Markets Group Inc. - CFO*

I mean on the OTCQX market where we saw that nice uptick in the annual renewal rate, and we generally sort of explained this, the OTCQX market is an annual subscription period, so we renew annually for a calendar year period. And if you recall, we introduced enhanced eligibility standards on our OTCQX market effective in 2017. And what we saw all through sort of 2017 and thereafter was an increasing downgrades there, but, as a result, a real uptick in the quality of companies on that market and what we ended up with, and it was one of the many benefits of enhancing those standards and really pushing for better standards on that market with a better overall product market fit within that market and just a higher quality of companies on the market overall.

For 2019, we're seeing some of that benefit, I think, as well as seeing some benefit from operational improvements and how we handled our renewal process, system enhancements that have just made us a little better handling that process. And I think both 2 factors combined really drove that nice 3 percentage point uptick in our renewal process.

In terms of compliance-related downgrade, I mean, on both markets on OTCQX, it's basically flat. On OTCQB, we see, again, ebbs and flows that it somewhat goes with the calendar of what is happening within that calendar period in terms of reporting and filing deadlines and small sort of changes that aren't super concerning to us, we call it out because we think it's just good disclosure and good information.

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

And this is Cromwell. If you look at the QX rule set, it's pretty well baked, while OTCQB, you'll see some tuning taking place for standards as we figure out of shaping the market to be a strong venture market that gives entrepreneurial management teams the chance to succeed.

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

I appreciate that. And then just one last one. You've highlighted in the release and in the Q, just on Canari. Can you then just talk a little bit about the product introduction, like, if it's significant or not and just maybe a little bit more color on that?

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

So the Canari is incremental significant. It's putting our data into an interface for users of our compliance data. And if you look at it, for the long-term side, broker-dealers, banks, investment managers have obligations -- have various obligations and then they have various business needs. Business wants to help valued customers do more business. And then they have regulatory under lots of regimes. And so for us is if we can make our data more useful, some of it is enhancing data and providing files into people's systems, but some of it is providing an interface. And this is for OTC securities and also exchange securities, we're seeing a lot of demand for because the same needs and risks exist there. So it's a way in deeper into the process, and it's great when we're providing an interface, a great feedback loop of talking to core customers. So that part of it is something that we're going to sell \$ 1 billion's worth of next week, no, but it is going to build and strengthen and expand us from being a source of data not

just about OTC securities, but exchange securities into different investment professionals within large and small firms that we highly value as our clients going forward.

Operator

Our next question is from Andrew Mitchell with Edison investments.

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

I just had 2 questions. One, I just want to make sure to understand the various remarks on expenses in the statement and on the call. Just thinking about the occupancy cost as you show them in the detail. I was wondering what the base level. Which period's base level should we look forward to add on the \$150,000 to \$180,000 to -- just to sort of look at that number going forward? And secondly, my usual question on the tax charges. I was wondering what a reasonable rate would be to assume going forward? Would 18% still be a sort of fair guess?

Beatrice Ordonez - *OTC Markets Group Inc. - CFO*

Andrew, thanks for your questions. I'll take both of those. So on the expense side, I mean, I think Q2 or Q3 of last year is a reasonable baseline to take that \$150,000 to \$180,000 range that we're giving in terms of the uptick in run rate. We started the move process in late Q3 into Q4, and that's where we started incurring some degree. We executed the lease in October for the new space, so that's when we started seeing overlapping rent obligations in terms of the 2 office spaces that we have. So if you take Q2 as a reasonable run rate and add on there, then I think you are in a good spot. The breakdown of that \$150,000 to \$180,000, about \$100,000 of that is base rent. We were very pleased with the deal that we were able to get in terms of Manhattan's real estate scene right now. We were very prudent. We feel it and really strategic around how we looked for space and we moved out of the very expensive submarkets that existed and exist in Hudson Square and the Soho region and down into the much more reasonably priced fi-di district -- financial district. So we're very comfortable that we've made a great long-term investment in terms of the upgrade of the space that we got and in terms of the uptick in rent that we took on. So that's sort of the baseline and the increment.

In terms of the effective tax rate, we will see a little bit of benefit this year from the FDII tax credit that I mentioned. We'll see a little bit of benefit in terms of R&D and potentially increase spend there, in line with increased headcount and more development on some of the products we've acquired as well as some of our trading systems. But broadly speaking, I would model out roughly flat versus last year. So your 18% effective tax rate is not too far off the mark.

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

And Andrew, this is Cromwell. I just -- moving offices -- having moved offices for the business, it's always a bit of a gulp to come into the market again and sign a 13-year lease, which we did in almost 12-plus years is -- but we're very lucky because we found a space that we were able to create good value out of and was a space that was a little bit of a white elephant because is -- otherwise, so it fit really well both sides of the deal. I believe we got good deal, so it put us into a position where we're in better shape going forward. The space is 10% bigger and it's really a much higher-quality space for us. And a company that was trying to manage and smooth numbers might not have invested in any other products and people and places to try and say, "Oh, we're stuck here, we're stuck here." My view is this is a space that we want to have a lot of success in for the next 12 years. And it's also a space that makes every one at the company excited to be building this for the next decade. But we need to be investing now to build the business going forward and taking ourselves to the next stage. So that's a part of -- and we've always said we're looking for long-term business growth and we're not going to be tied to meet -- meeting a quarterly margin if there's opportunities to grow the business. I can tell you, our cost real estate will be a lower percentage year 13 of the lease, of our revenue itself.

Operator

(Operator Instructions) Our next question is from Daniel Baldini with Oberon Asset Management.



Daniel Baldini - *Oberon Asset Management LLC - Managing Partner & Chief Compliance Officer*

So just the other day, I saw a little article about a company called Carta, and says here, "Carta, a platform that allows users to buy, sell and trade privately held assets announced on Monday closed \$300 million in Series E funding that value the company at \$1.7 billion." Founder and CEO Henry Ward told Business Insider that the influx of funds would help the company "blur the lines" between public and private investment assets and expand its presence in traditional Capital Markets. So I'm just curious, this thing is worth at \$1.7 billion. They've got \$300 million. Is there -- what's the chance that they're going to try and do what you're doing? Or what is the opportunity that you can maybe do what they're trying to do, which seems to be?

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

Yes. Thank you, Daniel, and this is Cromwell. It's a good question because since the -- when we started out making this market more electronic and then -- and connecting broker-dealers and then on a second place, when we started out creating products for companies to provide consistent disclosure and demonstrate regulatory compliance, both of those times, people were very dismissive saying about whether we would succeed or whether it's worth it, whether anybody care. And then after we've been doing it for a little while, there were things like SecondMarket. There's been numerous other. There was lots of crypto exchanges. Well, they call themselves exchanges, but they weren't even broker-dealers. And there's always going to be someone trying to reinvent places -- spot in the space that should keep us looking at and seeing if we can take some of their successful models and use them to help serve the broker-dealers who are our clients. And so the private market space is very interesting. We're looking at ways to help securities that have regulatory restrictions on them to be able to more easily be traded by broker-dealers. And -- but there's always going to be an exciting new platform out there that is -- and it's the joy of competition that is going to keep some fire in our her belly and hustling along. So that's my -- that's all I can say is about that, but SecondMarket have the same excitement and they had a hard time building a sustainable revenue model. This is a tough space. And so -- but e-mail me whenever you see a good idea on how we can serve our clients better. I'm all open -- all ears and eyes.

Operator

There are no further questions at this time. At this point, I'd like to turn the call back over to Cromwell Coulson for closing comments.

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

Thank you all for joining today. I hope you will take the time to read through our quarterly report in more detail. We appreciate the opportunity to share insight into our performance and the trends and risks we expect that impact the company, respectively. We are excited to continue to execute our strategy and build shareholder value over the long term. On behalf of the entire OTC Markets Group team, thank you for your support.

Operator

This concludes today's teleconference. You may disconnect your lines at this time, and we thank you for your participation.



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