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OTCM - Q4 2019 OTC Markets Group Inc Earnings Call

EVENT DATE/TIME: MARCH 05, 2020 / 1:30PM GMT



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PRESENTATION

Operator

Ladies and gentlemen, thank you for standing by, and welcome to the OTC Markets Group Fourth Quarter and Full Year 2019 Earnings Conference Call and Webcast. (Operator Instructions) Please be advised that today's conference is being recorded. (Operator Instructions)

I would now like to hand the conference over to your speaker today, Mr. Dan Zinn, General Counsel. Thank you. Please go ahead, sir.

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 Full Year 2019 Earnings Conference. 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 2019 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. - President, CEO & Director*

Thank you, Dan. Good morning, and thank you, everyone, for joining the call. The fourth quarter and full year 2019 saw increased revenues across each of our business lines. We will cover our financial results in greater detail in a few moments. Briefly, I would like to highlight that our fourth quarter results delivered 4% top line revenue growth, with operating income down 2%. For the full year, top line revenue increased 6%, while operating income declined 9%. The decrease in operating income was due in large part to investments made in staff and in our infrastructure. As we have noted during the past calls, 2019 was a year in which we invested in the people and the platform that will help drive future sustainable growth. Specifically, we invested in human capital by increasing the headcount during the year and also successfully completed 2 large capital investment projects. First, moving our corporate headquarters to 300 Vesey Street in Downtown Manhattan; and second, a refresh of our primary and backup data centers. It was inspiring to watch our entire team led by Bea, complete our move on time and with minimal disruptions. I also take great pride in the way our engineering teams executed the complex infrastructure upgrade of our data centers ahead of schedule while delivering 100% uptime of our core OTC Link ATS systems during regular market hours. System reliability remains paramount, and 2019 provided an excellent example of our constant drive to enhance our functionality, while sustaining a culture of compliance and reliability. To stay competitive over the long term, our management, product design and engineering teams must always seek to proactively build a better technology platform. I'm similarly proud of our marketing teams' work this year, including initiatives that focus on additional digital communication channels, allowing us to better connect companies and their investors. Across marketing, sales and technology, we embrace a future that is online, data-driven and



social. In corporate services, during the fourth quarter, we had 18 companies graduate for our markets to a National Securities Exchange and a total of 57 such graduates during 2019. We celebrate our role as the world's most successful venture market as we continue building the features and functionality that provide transparent and cost-effective public markets for companies to thrive and grow over the long term. In particular, we view international companies and community banks as key to the ongoing expansion of our OTCQX and OTCQB markets.

In 2019, we are also devoting resources to expanding our analytics offerings. Our market data licensing business incorporated risk and performance analytics data for banks and introduced a web-based compliance data tool, Canari. More recently, in February, we unveiled U.S. bank holding company corporate structure data on our website, creating additional transparency for the more than 550 community banks in our markets as well as for U.S. exchange listed banks. To achieve our mission of creating better informed and more efficient financial markets, we must keep adding useful data streams and driving enhanced market transparency. Regulators placed a focus on several aspects of our markets during the past year. Most notably, the SEC proposed amendments to Exchange Act Rule 15c2-11. This rule governs the publication of quotes on systems like OTC Link ATS. The SEC's wide-ranging proposal has been met with the perspectives of individual and institutional investors, broker-dealers, companies, advisers, market operators like ourselves and regulators. In November and December, we submitted comments to the SEC's proposal and have met SEC staff members on a number of occasions to discuss our views on how to responsibly modernized Rule 15c2-11 for the benefit of all market participants. As noted in our comment letters, the SEC's proposal includes a number of positive aspects such as recognizing our OTCQX, OTCQB and current information disclosure standards and allowing brokers and others to rely on our designations to determine whether companies meet the rule's eligibility requirements. These improvements would streamline the onboarding process for companies looking to access the public markets and allow our OTC Link ATS greater control, when we onboard new companies and would give us the ability to initiate quotations in their securities. Notably, however, the SEC's proposal fails to address what would happen to companies. And more importantly, their outside investors, when they no longer qualify to be the subject of public market maker quotes. Brokers still need the best execution. And we should be careful to protect the property rights of minority investors. As detailed in our comment letters, our proposed solution and expert market for professional, sophisticated investors, would allow all investors to continue to receive best execution from their brokers, while giving effect to the SEC's investor protection goals by thoughtfully gating these securities and markets. If adopted as currently proposed, a final rule is likely to have some positive impact on our ability to develop future revenue streams, but would also introduce complexity and limit the number of securities eligible for quoting on our markets, which is likely to have a negative impact on our revenue. We look forward to continuing to work closely with the SEC on this important rule making. Outside of SEC rule making, we remain focused on gaining regulatory recognitions for our OTCQX and OTCQB markets. At the state level, we continue working with NASA and individual state regulators towards our goal of achieving nationwide blue Sky exemptions. Securities on our OTCQX market are exempt in 36 states with OTCQB securities exempt in 33. On a positive note, Virginia State Legislator recently passed a bill allowing for recognition of our markets there. And we look forward to adding Virginia to our list of state exemptions during 2009. This is a legislation that was driven by banks, community banks that are traded on our markets today. At the federal level, we are extremely encouraged by the recent introduction of the ESOP Fairness Act. A bipartisan bill in the house in Senate that would allow qualified OTCQX and OTCQB companies to more efficiently offer employee stock ownership plans. This rulemaking can -- this legislation can lower cost for public companies and make it easier to align employees and shareholders. We also continue to help drive efforts for these companies to gain margin eligibility for their shareholders. Our September visit to Washington, D.C. with members of the OTCQX advisory Council helped greatly in advancing each of these vital initiatives impacting small public companies across the U.S. Finally, I am pleased to announce that on March 4, our Board of Directors declared a quarterly dividend of \$0.15 per share payable later this month. The dividend reflects our ongoing commitment to provide superior shareholder returns. With that, I will turn the call over to Bea.

Beatrice Ordonez - OTC Markets Group Inc. - CFO

Thank you, Cromwell. As we close out our reporting for 2019, I want to take a moment to thank our fantastic finance and legal teams for all of their hard work over the last several weeks. I will now review our results for the fourth quarter and year ended December 31, 2019. Any reference made to prior period comparatives refers to the fourth quarter of 2018 or the year ended December 31, 2018, as appropriate. For the fourth quarter, we generated \$16.1 million in gross revenues, up 4%, with all 3 of our business lines delivering quarter-over-quarter growth. Revenues from our corporate services business were up 6%. OTCQX revenues were up 12%, in line with the higher number of companies on the market, strong sales in the prior year and for 2019 together with an uptick in our 2019 renewal rate from 91% to 94% all contributed. For reasons I will touch on shortly, we saw a year-over-year decline in the number of companies on our OTCQB market and a roughly 2% decline in corresponding revenues in the fourth quarter. Market data licensing revenues were up 4%. Sales of our Data File products and sales of, and upgrades to premium versions of our



compliance offerings drove a 23% increase in related revenues. As of March 1, 2020, 42 subscribers use our products to streamline and automate their compliance processes, including almost every major bank, broker-dealer and clearing firm that is active in the OTC space.

In 2020, we plan on rolling out additional compliance solutions that can better serve participants in our markets. For the current quarter, we also saw growth in the number of professional users of our market data and a 4% increase in related revenues. In our trading business, revenues from our OTC Link ECN were up 26%, while revenues from quotes on our OTC Link ATS were up 9%. These increases offset a small decline in revenues from messages on our OTC Link ATS and drove a 1% quarter-over-quarter increase in trading revenues. With 59 subscribers as at March 1, 2020, our OTC Link ECN continues to win market share. And as we onboard new subscribers, we expect to continue to grow our revenues from this offering. Turning our attention now to our full year results. For 2019, we generated gross revenues of \$62.8 million, up 6%. Corporate services revenues were up 8% with QX revenues up 14% and QB revenues up 6%. During 2019, we added 123 QX companies, broadly flat to our prior year sales. International companies have been a significant driver of this growth and made up 62% of the 442 companies on the market at year-end.

In 2020, we will continue to focus on driving international sales through our London presence, by our enhanced marketing assets and by strengthening our relationships with global exchange operators. For the OTCQX market, renewals are handled annually on a calendar year basis. In respect of the 2020 subscription period, our retention rate was 92%. A 2 percentage point decline over 2019. For 2019, we saw a decline in the number of companies joining the OTCQB market from 243 to 202 companies. This drove a contraction in the ending number of companies on the market. We are a very active cannabis market in 2018, which helped drive sales. Further, in 2019, we raised market standards on our OTCQB market. This has had the effect of reducing the available pool of qualifying domestic companies. In revenue terms for the full year, the decline in the number of QB companies was offset by the full year impact of price increases for renewing subscribers. Our market data business delivered 4% revenue growth. As already discussed in the context of our quarterly results, new sales of our data license products, particularly our compliance products, drove much of that increase, delivering a 20% increase in related revenues. Additionally, year-over-year growth in the number of professional users drove a 4% increase in corresponding revenues. OTC Link revenues were up 4% for the year with a 71% increase in revenues from our OTC Link ECN, the primary driver.

Turning now to expenses. On a quarter-over-quarter basis, operating expenses were up 7%, with compensation expenses up 10% and IT and infrastructure costs up 8%. In terms of our compensation costs, increased headcount, the impact of annual salary raises, rising stock compensation expense and an increase in the cost of providing health care coverage have been the primary drivers. Increased spend related to system security, an increase in development and support costs related to our OTC Link ECN and our Caravan and VIC businesses and certain onetime costs drove the uptick in our technology spend in the quarter. Our occupancy expenses were down 28% over the prior quarter, reflecting overlapping rent obligations in the fourth quarter of 2018 that did not repeat in the current quarter. On a year-over-year basis, operating expenses were up 13%, which included onetime expenses of \$695,000. Compensation costs make up 65% of our total expense base and increased 13% year-over-year for the reasons already discussed in the context of our quarterly results. On a year-over-year basis, our information technology costs increased by 15%, again for the reasons discussed. For the full year, our occupancy costs increased by 21%. On a run rate basis, our occupancy costs following our move to new corporate headquarters increased by approximately \$150,000 per quarter. For the fourth quarter, income from operations was down 2%, while for the full year, we saw a 9% decline. Net income for both the quarter and for the full year declined by 8%. In addition to certain GAAP and other measurements, management utilizes a non-GAAP measure, adjusted EBITDA, which excludes noncash stock-based compensation expenses. On a quarter-over-quarter basis, adjusted EBITDA increased by 4% to \$5.8 million. For the full year, our adjusted EBITDA was \$22 million, down 4%. Cash flows from operating activities for the full year amounted to \$21.4 million, a 5% decline, while free cash flows for the year declined 28%, reflecting the significant capital investments made during 2019. In the context of our investor focused capital allocation policy, we return cash to investors in the form of dividends and through our stock buyback program. During 2019, we returned a total of \$16 million, up 5% over the prior year.

In closing, in 2019, we delivered revenue growth across all 3 of our business lines and expanded our suite of products, both through organic initiatives and through acquisitions. We invested in the people, technology and facilities that will drive future sustainable earnings growth. As we look ahead to 2020, we expect to deliver continued revenue growth and to see some margin expansion. We will continue to focus on organic initiatives as well as on evaluating strategic acquisition opportunities, all with a view to drive sustainable revenue and earnings growth that can deliver long-term value 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 Chris McGinnis with Sidoti & Company.

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

I was wondering if you could just maybe start off and address maybe the coronavirus and any possible impact to the business that you could see? I know it's highly subscription-based, but just give your thoughts around that offering?

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

Sure, Chris. I'll leave this off, and I think Bea will talk a little bit more about the specific financial impact. Obviously, first and foremost, our concern is for our employees and for those that interact with to visit our office and our customers. And so we have a number of communications internally to make sure that everybody understands what's going on and that we have the most up-to-date information possible. On a separate side, in terms of the business operations, we have business continuity plans as we're required to and have long had in the broker-dealer side to make sure that we can continue to operate our market. Regardless of what eventuality may come. So that's been a primary focus in kind of the short term. In preparing for and communicating around the coronavirus. And I think we can talk a little bit more about how we think about it from an economic perspective. .

Beatrice Ordonez - OTC Markets Group Inc. - CFO

Sure. I mean, certainly, look, the first thing I would note is that we devote a lot of real estate in our annual report to talking about the risk factors that both stakeholders in general should look at. And we cover, obviously, the macroeconomic factors, including pandemic rest, that could be a driver here. But as a certain -- as a general matter, certainly, if you were to see prolonged economic disruptions, potentially leading to a global downturn or recession, we would obviously expect to be impacted. As you noted, 90% or close to 90% of our revenue flows of subscription. But we would expect our clients to be impacted, our uses to be impacted, and for there to be some downstream impact to our financial results as well. It's obviously hard to your question, I think, as sit here today to try and estimate the scope and the materiality of that impact. So we're really focusing our efforts now, as Dan said, on preparedness in the short-term and on continuing to operate and run the business and ensure that we stay informed and on top of development.

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

Sure. I appreciate that. And then second question, can you just maybe provide any insight on the alliance with more capital and it's been 5 months and maybe the kind of the key takeaways from that so far?

Beatrice Ordonez - OTC Markets Group Inc. - CFO

Yes. Certainly, Chris. So we launched that in October. And as we said in some of the press releases, and I think we touched on in the last call, what we're really doing is providing companies on our market with access to a technology platform that really streamline the capital raising process, also range of offering sites. That technology platform can be integrated into an issuer's website. We can potentially integrate some of the functionality into our own website to leverage the many millions of page views that we get. But really for us, while it's not a short-term driver of revenue necessarily. We view it as an important strategic step into an important area for our markets and for our issuers. We talk to our issuers a lot across a range of issues. And one of the top issues that they talk about is access to capital, the complexity surrounding it, the cost of raising capital and

so on. So we view it as just sort of a value-add and a expansion of our product suite, if you like, into an area, private markets, exempt offerings and so on. That really is going to continue to grow in importance and is a particular interest to our issue.

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

And Chris, this is Cromwell. This -- to reiterate what Bea said, this is a long-term aim is online capital raising. And when the SEC implemented their first pass at the Jobs Act. I think we can all agree, they didn't get it right. And it didn't work as well. For the new Jobs Act offerings as people quote. That said, the SEC just yesterday announced a refresh for Reg A, for crowd funding. So these types of offerings are moving in the right direction. And we want to be part of fostering, the ability of companies that are public to efficiently raise capital using technology in a direct manner to investors. .

Operator

Our next question comes from Andrew Mitchell with Edison.

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

Could I start on the regulatory front with the policy statement on suddenly traded securities. So I know you haven't made a comment on that yet, but I don't know if you can give any provisional headline reactions.

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

Sure. Andrew, thanks for the question. This is an issue we've been looking at for a long time. It is related in many ways to various legislative proposals around venture exchanges and the like. And we've taken a position in some related comment letters, you're right that we haven't submitted a comment letter on that proposed specifically. But we've talked certainly around Capital Hill and with regulators at the SEC around our feelings. If you're going to have a venture market, a market that really helps grow companies in the way that Cromwell was talking about using some of these exempt offering types and seeing that continue and grow as they become publicly traded companies, we feel we're best positioned to do that. We talk frequently. As Cromwell noted earlier in his comments about being the world-leading venture market. And so we view all of this as a piece with that. With respect to the policy statement from last year and NASDAQ's recent response to it, we don't think that suspension of unlisted trading privileges is really the right direction for markets to go in. But we're going to look at the proposals holistically, we're going to follow whatever rule-making process comes of this. And we will certainly be out there making, I think, comments with the SEC and also just with our subscribers and with our community more generally.

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

And then sort of noted the comments earlier about the macro uncertainties, but I was just wondering, after a very good year in terms of adding international corporate clients. I was wondering how the -- how you feel the year has started in terms of interest and appetite?

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

We continue to be very bullish around the global opportunity. We think our value proposition is proven over a long time and with some very large mega cap global companies, who see the value in accessing the U.S. capital market cost effectively in a super streamlined way. So we remain bullish. We're going to continue to, as I said, focus resources and our efforts on doing that. Obviously, there's macro uncertainty to a certain degree, there's always uncertainty. So we're going to continue along the path that we're on because we see the long-term opportunity around the global markets than our markets in general.



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

And Andrew, this is Cromwell. The part of what we've always been building for global companies is a way to electronically distribute their information into the U.S. and demonstrate their levels of compliance electronically. And if you look at the things we've added on the Virtual Investors Conference. That's another way to broadcast one-to-many conversations. And do it in an effective manner, data-driven and reach the broad and deep breadth of U.S. investors, a wide range from retail to institutional, to advisory. And so as people change in the industry of thinking of face-to-face meetings and really thinking how can I be more effective in filling up the information channels. Long term, we think that's a good trend. Short term, there's always going to be volatility.

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

Sure. And then I was looking at the somewhat more detailed point, but I was looking at the cost, and you've highlighted the one-off costs that presumably we can just assume don't recur? I know it's a smaller number, but I noticed the depreciation and amortization level in the final quarter appear to step up. Just wondering whether is there any one-off in that or if we could -- should just assume as we normally would, that, that was the run rate going forward?

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

Andrew, at a high level, I actually hope our data center refreshes do reoccur, but in 3 to 5 years. So these are investments, and we don't try to streamline them. But -- and then I'll hand it off. It is because we're building for the long game here. And -- but I'll hand it off to Bea to get into the specifics.

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

Sure. No, I mean, there's nothing particularly onetime in that number. As we've noted throughout 2019, we made some significant investments. The first one was the move and we moved in, in March. So that's when you started to see the upticks there from those assets coming into service. And the other big capital project was the data center refresh that Cromwell's just referred to, and we completed that in early fourth quarter ahead of schedule, I might add. So that's where you're seeing that there. To Cromwell's points, these are big capital projects that don't occur annually, but that are necessary for us just to make sure we have the best facilities and technology available for us to run our business.

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

And Andrew, I think you'll notice, if you look at our Instagram feed, you'll see we now have a bell ringing sound. We also have a broadcasting studio. We also have the ability to broadcast investor meetings or conferences. So at the new space with high quality. So these are all kind of changes in the platform of how we take our spot at the center of our community and serve our clients in a useful manner that's cost-effective and efficient.

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

Sure. And then just one last one. I think you usually note the limited addressable market for OTC Link ECN. Obviously, that's been building up quite rapidly, both in terms of subscribers and revenue. I'm just trying to sort of gauge what there is still to go for? Should we be looking at, say, the number of subscribers versus ATS? Or is there some other sort of way to gauge this?

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

Look, we don't necessarily sit there and mathematically try and size the market at this level. We're continuing to add subscribers, as we noted, we saw a 71% uptick in year-over-year revenues in 2019. And certainly, I think we can grow that. It's not a finite pie exactly, I think, with the right



functionality and with good technology and with good service, you can bring people to the market that perhaps not, have not played in the OTC space historically. But certainly, what we're highlighting in our annual report and in our disclosures is that 1 million doesn't become 50 million, right? So we're trying to sort of, obviously, provide the disclosure that says that there's not -- there's a cap on this eventually, right? So I don't know that I would say 59 subscribers look at our total subscribers on Link at roughly 90, 91, 92, therefore, we can add 40. It's a slightly different product offering. And we're just going to make sure we target the broker-dealers that can benefit from this unique offering in the market. Onboard them and compete aggressively for their business. That's what we've always done. We're here to serve the broker-dealer community to earn their business and to earn their trust, and that's what the ECN as well as our other trading businesses are about.

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

And Andrew, it is -- also add a running market micro structures. So while we may fill 1 niche, there's always another niche to go address. And if we can do it in a cost-effective and regulatorily compliant manner for our broker-dealer clients, there should be opportunities to take what we learn on each path at every stop.

Operator

And at this time, I'm showing no further questions. I'd like to turn the call back over to CEO, Cromwell Coulson for any closing remarks.

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

Thank you all for joining today. I encourage you to read our annual report in more detail. As always, we appreciate the opportunity to discuss our performance and how this may impact the company. We are excited to build on our strategy and grow shareholder value over the long term. On behalf of the entire OTC markets group team thank you for your support.

Operator

Ladies and gentlemen, this concludes today's conference call. Thank you for participating. You may now disconnect.

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