The UK Listing Rules and Firm Valuation

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Outline

- Background: policy and literature review
- Methodology
- Results and interpretation
- Conclusions

Policy Background

- Consultation on regulation of investment entities (CP06/4, CP07/12): which super-equivalent listing rules add value?
- Implications for trading companies (DP 08/1): should UK trading companies be given a choice between directive minimum and super-equivalent listing regimes?

Literature Review: Valuation Effects of Super-equivalent Listing Rules

- Many studies suggest that higher corporate governance standards tend to be associated with higher valuation.

- However, at some point costs will outweigh the benefits of further regulation (Sarbanes-Oxley Act?).

→The literature review provides little guidance on the more granular questions that have arisen during the UK Listing Rules review.

Literature Review: Mandatory v optional standards

opt-in standards:

- Firms can choose corporate governance standards that are most suitable for their business.
- ***but*** investors may find it difficult to assess corporate governance standards adopted by individual firms.

mandatory standards

- Investors can rely on the adoption of uniform minimum standards across a whole regulated market segment.
- ***but*** one corporate governance standard may not fit all firms.

→ **Investors' ability to assess standards adopted by different issuers needs to be considered when deciding whether regulatory requirements should be optional or mandatory.**

Dual standards – the Main Market and AIM

Admission process	
AIM	**UK primary listing on the Main Market**
• No minimum percentage of shares to be in public hands	• Minimum 25% shares in public hands
• No trading record requirement	• Normally three-year trading record required
• Admissions documents not pre-vetted by Exchange or UKLA	• Pre-vetting of admission documents by the UKLA
• Nominated adviser required at all times	• Sponsors needed for certain transactions
• No minimum market capitalisa-tion	• Minimum market capitalisation of £700,000

Dual standards – the Main Market and AIM

Continuing obligations	
AIM	**UK primary listing on the Main Market**
• Shareholder approval for corporate acquisitions or disposals required only if transaction contemplated is at least equal to the value of the company	• Shareholder consent required for corporate acquisitions or disposals of much lower value
• Shareholder approval for related party transactions not required - an announcement to market that the transaction is fair and reasonable is sufficient	• Shareholder approval required for related party transaction
• No onerous requirement to produce listing particulars and no restriction on market price for fund raising	• Restrictions on placing of shares for additional fund raising

Dual standards – the Main Market and AIM

Continuing obligations	
AIM	**UK primary listing on the Main Market**
• No prescriptive corporate governance requirements and Combined Code does not formally apply but companies encouraged to comply	• Firms have to comply with or explain non-compliance with the Combined Code and comply with other relevant Listing Rules
• Less prescriptive requirements on nature of financial information to be disclosed	• Firms have to comply with the more stringent disclosure requirements set out in Listing, Disclosure and Transparency Rules

Do dual standards matter?

- Does the firm's choice where to list affect the value of the company?

- One way to look at this is:
What happens to the share price if a company announces a switch from AIM to the Main Market (or vice versa)?

Event study - What might the results tell us?

I. Values increase for moves in either direction

→benefits of "optionality"?

II. Values fall for moves from Main Market to AIM and values increase for moves in the opposite direction

→benefits of high across-the-board standards?

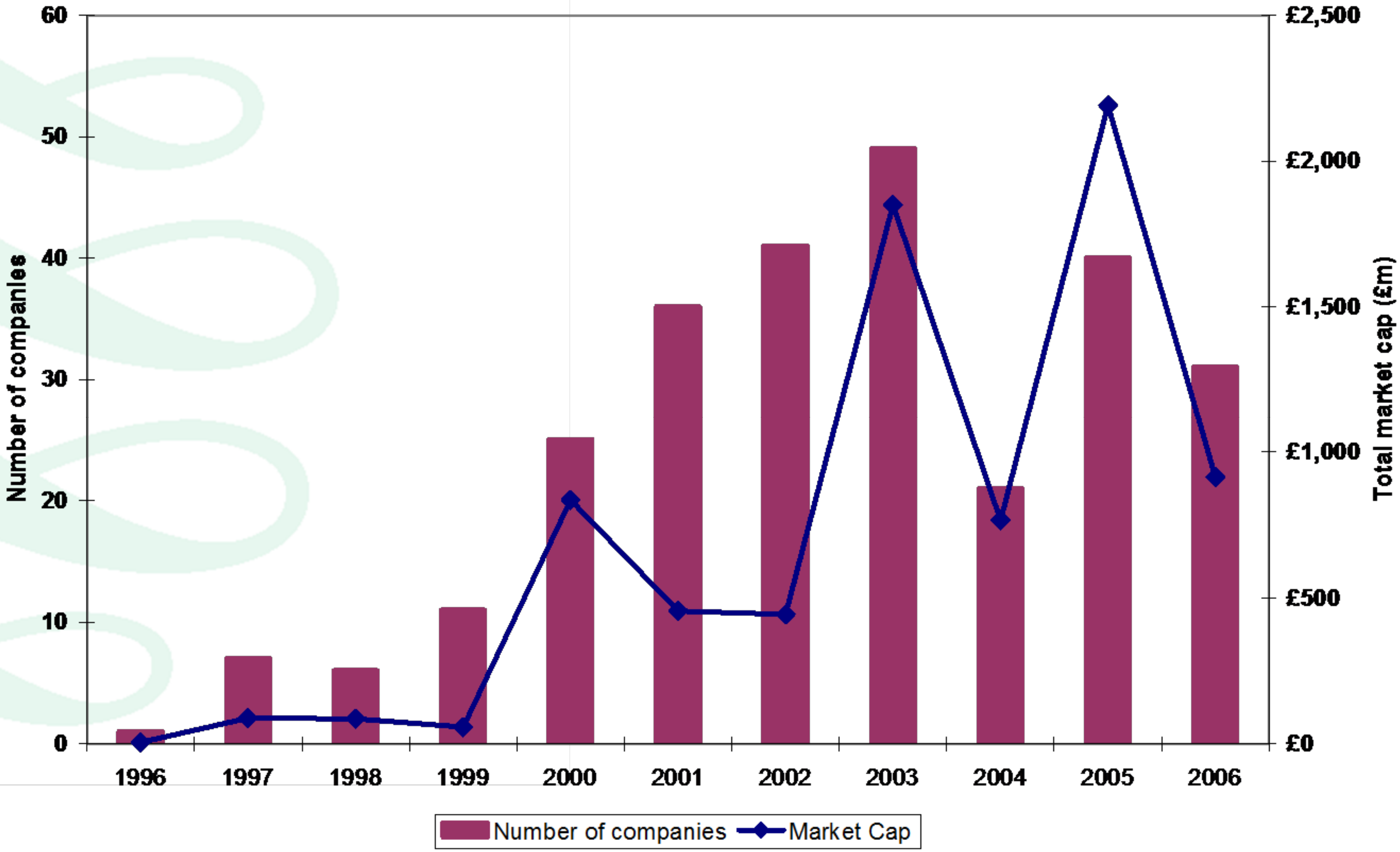
III. Values not substantially affected by regulation

→regulation not an important factor for investors?

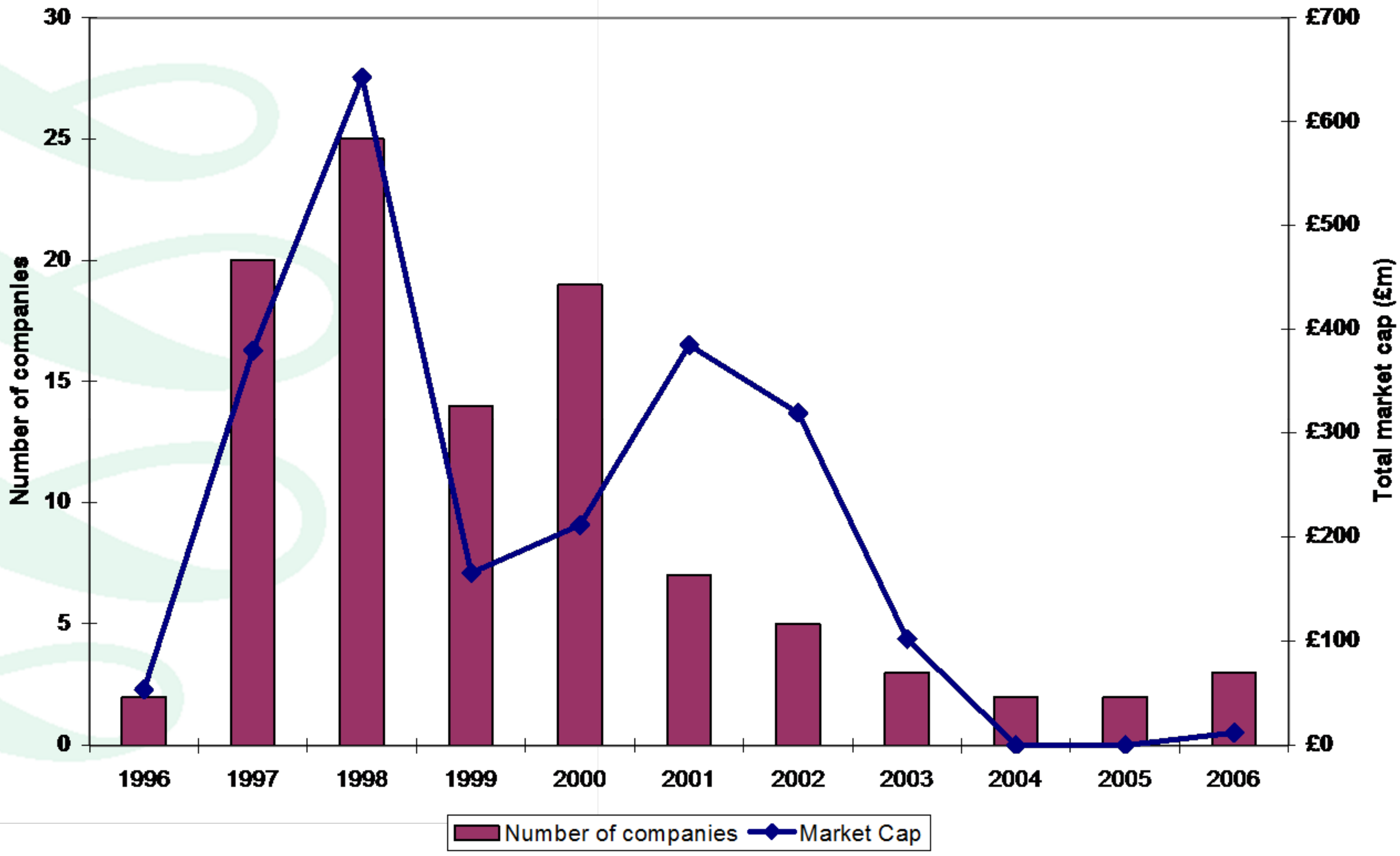
Announcements anticipated?

- <u>Caveat</u>: there are factors other than regulatory differences that might explain share price reactions in our study

Moves from Main Market to AIM



Moves from AIM to Main Market

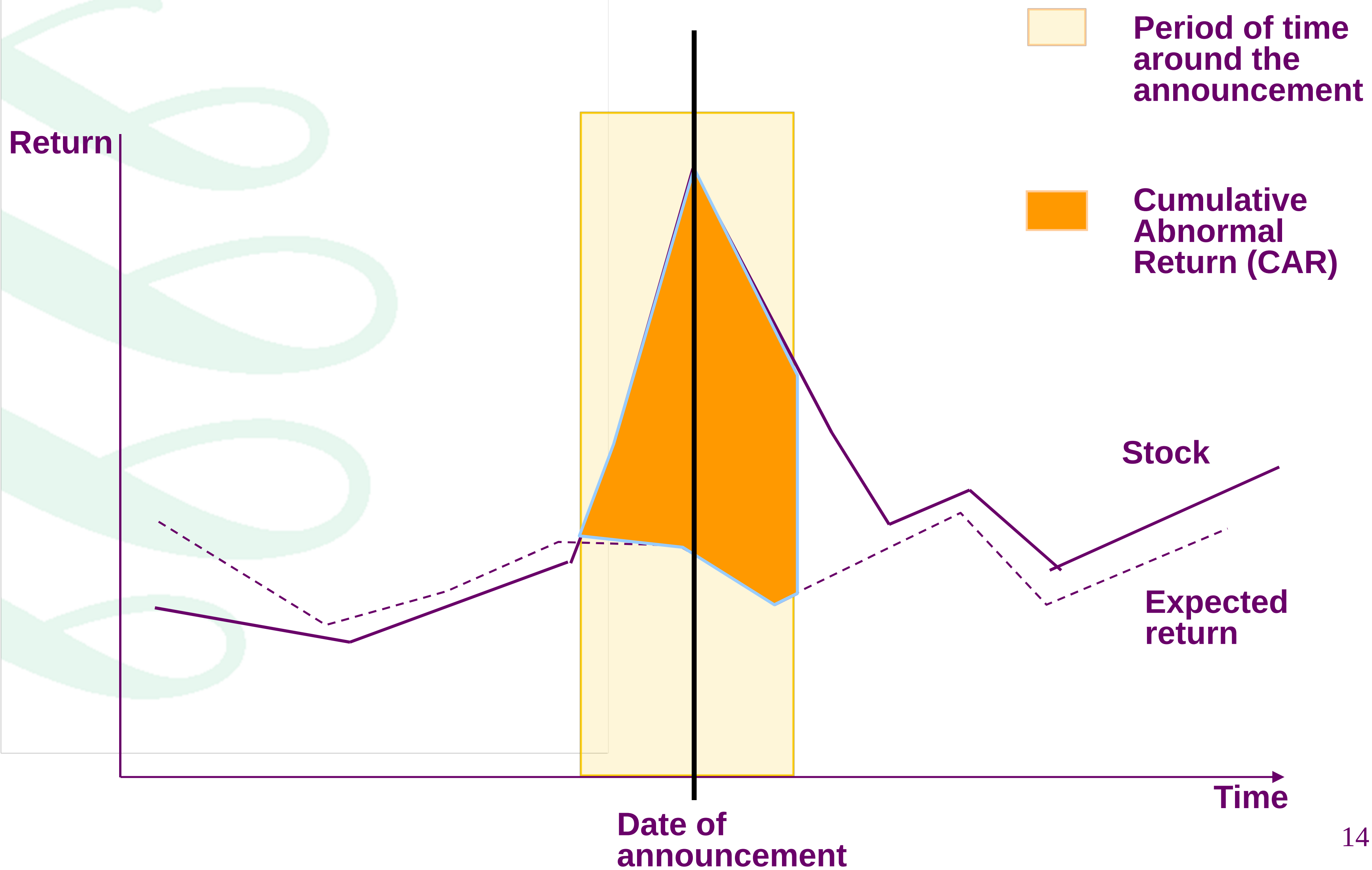


Description of sample

	AIM to Main Market		
	Clean Sample	Equity Issuers	Total
Number of firms	36	31	67
Average market capitalisation (£m)	71.8	66.1	69.1

	Main Market to AIM		
	Clean Sample	Equity Issuers	Total
Number of firms	139	51	190
Average market capitalisation (£m)	21.0	20.7	20.9

Event Study – Firms switching from AIM to Main and vice versa



Event Study – Setup I

Returns model	market model, if not significant: constant-mean return model
Market model	$R_{it} = \alpha_i + \beta_i R_{mt} + \varepsilon_{it},$ $E(\varepsilon_{it})=0;\ Var(\varepsilon_{it})= \sigma^2_{\varepsilon_i}$
Constant-mean return model	$R_{it} = \mu_i + \eta_{it},$ $E(\eta_{it})=0;\ Var(\eta_{it})= \sigma^2_{\eta_i}$

R_{it}*: period-*t* return on stock *i

R_{mt}*: *return on market portfolio

μ_i*: mean return on stock *I

***ε_{it}, η_{it}* : disturbance terms**

Event Study – Setup II

Event window	2 days before announcement until 1 day after announcement
Estimation window	240 trading days before the 2 days pre-ceding the announcement
Test for significance	Distribution generated via bootstrapping, one-sided test for significance at 10%-level

Event Study – Robustness Checks

	General setup	Robustness checks
Event window	2 days before announcement until 1 day after announcement	different event windows in the period of 5 days before and 5 days after the announcement
Estimation window	240 trading days before the 2 days preceding the announcement	different pre- and post-announcement estimation windows
Returns model	market model, if not significant: constant-mean return model	constant-mean return model, excess-return model

Results of study – AIM to Main Market

	AIM to Main Market	
	Clean Sample	**Equity Issuer Sample**
Number of firms	30	29
Positive reaction	16	21
Negative reaction	14	8
	Average	*Average*
CAR	**-0.8%**	**6.9%**

- Equity issuer sample: predominantly large positive CARs
- Clean sample: on average small CARs

Results of study – Main Market to AIM

	Main Market to AIM	
	Clean Sample	**Equity Issuer Sample**
Number of firms	136	48
Positive reaction	56	15
Negative reaction	80	33
	Average	*Average*
CAR	**-1.5%**	**-9.1%**

- Equity issuer sample: large negative CARs
- Clean sample: much smaller negative CARs

Interpretation

- Signal of performance effects
- Liquidity effects
- Index and investment mandate effects
- Tax effects

Signal of Performance Effect

- Hypothesis: Announcements of transfers between venues may be understood as a signal of future performance

	Main Market to AIM	AIM to Main Market
Signal	firm may have financial difficulties	switch as signal for growth story
Indicator	weak historic share price performance + negative CAR	strong historic share price performance + positive CAR

Signal of Performance Effect – AIM to Main Market

	2 years before announcement	
	Clean Firms	Equity Issuers
Number of firms	20	21
Positive reaction	16	15
Negative reaction	4	6
	Average	*Average*
Outperformance	**219.2%**	**197.7%**
CAR	**-0.8%**	**6.9%**

Before announcement:

- both samples are historic outperformers
- equity issue signal of performance?

Signal of Performance Effect – Main Market to AIM

	2 years before announcement	
	Clean Firms	**Equity Issuers**
Number of firms	134	46
Positive reaction	47	11
Negative reaction	87	35
	Average	***Average***
Outperformance	**-17.1%**	**-24.2%**
CAR	**-1.5%**	**-9.1%**

Before announcement:

- both samples are historic underperformers
- equity issue signal of performance?

Does the market get the signal right? – AIM to Main Market

	2 years after announcement	
	Clean Firms	Equity Issuers
Number of firms	29	27
Positive reaction	10	6
Negative reaction	19	21
	Average	*Average*
Outperformance	**-21.3%**	**-20.5%**
CAR	**-0.8%**	**6.9%**

After announcement:

- on average underperformance
- for equity issuers this is consistent with literature on equity offerings and IPOs

Does the market get the signal right? – Main Market to AIM

	2 years after announcement	
	Clean Firms	Equity Issuers
Number of firms	119	41
Positive reaction	56	14
Negative reaction	63	27
	Average	*Average*
Outperformance	**7.2%**	**-11.4%**
CAR	**-1.5%**	**-9.1%**

After announcement:

- equity issuers do on average underperform
- for clean sample tendency is not clear.

Liquidity effects

- Liquidity tends to be higher on the Main Market than on AIM
- This might affect changes in valuation following an announcement of a switch
- We investigated this hypothesis but were unable to confirm it
- We also lack any reason to suppose that they would explain the differences between the event study results for the two samples

Investment mandate and index effects

- Switching between Main Market and AIM could lead to inclusion / exclusion
  → in FTSE indices and
  → investment mandates

- Demand effect with consequences on share prices and liquidity?

- No evidence for index and investment mandate effects (main reason: firms in our sample are very small)

Tax effects

- Tax advantages for AIM shares (taper relief) could in theory have a significant impact on share prices when firms switch between the markets
  → increasing CARs for issuers transferring to AIM
  → decreasing CARs for issuers transferring to the Main Market

- We don’t observe these effects in our sample.

- Tax effects should be similar for all firms, so tax cannot explain the differences between our equity issuer sample and our clean sample.

Conclusions

- We cannot conclude from our results that the higher regulatory standards on the Main Market do not affect the valuation of the many larger issuers which would not contemplate switching regimes.
- However, for most of the firms our study focuses on, the differences in regulation between the Main Market and AIM are EITHER not a significant factor driving valuation OR not one which we can isolate empirically.
- Expectations about future growth appear to matter more, at least for firms announcing an impending equity issue alongside their intention to transfer between markets.

- **Any comments or questions?**