The Cost of Capital: An International Comparison June 2006

London Stock Exchange

Oxera

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EXECUTIVE SUMMARY

City of London

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Foreword

Michael Snyder
Chairman, Policy and Resources Committee
City of London

Earlier this year in a policy paper entitled *Financial Services in London: Global Opportunities and Challenges*, HM Treasury analysed the factors underpinning London's position as the world's leading international financial services centre. It explains that, 'to ensure that the competitiveness of the overall business environment is not undermined, it is essential that the UK's regulatory regime for financial services, and its administration of tax and areas of business regulation, are transparent and responsive to changing business demands. Government policy needs to respond swiftly and flexibly to the development of new financial products and to the emergence of new business structures.'

The Chancellor, Gordon Brown, in his Foreword recognised that supportive public policy is extremely important to London's competitive position, noting that 'it is the Government's ambition to ensure that, through London's international markets, Britain strengthens its position as unambiguously the world's leading centre for international finance'. Yet if we are to maintain this lead, we must first measure our position relative to our competitors in order to identify areas requiring further policy attention. I am therefore delighted that this new piece of research, undertaken for us by Oxera Consulting, assists in this task by comparing the cost of listing and raising capital on different exchanges in Europe and the United States.

Oxera's independent conclusions suggest that on an array of measures – from IPO costs, trading costs and perceived corporate governance standards - London offers a highly competitive environment in which to conduct business relative to its major challengers. The pool of liquidity, availability of capital, technology platforms and the quality of research concentrated in London all contribute to its success. Yet as the research makes clear, there are some downsides.

This report provides a salutary lesson for governments in their attempts to create more intensive regulatory environments for business. Benefits must be set against the costs that companies incur when complying with rules and standards, and it is very easy to tip this balance in the wrong direction through disproportionate regulation. As this report shows, the Sarbanes-Oxley corporate governance reforms in the United States have increased the compliance costs of a US listing with no significant benefits beyond those that already apply under the London regime.

As international competition becomes more intense, competitive and efficient trading exchanges, underpinned with proportionate regulatory environments, matter even more. I hope this report contributes to the debate as to how we can best promote open, transparent and competitive markets in financial services so that London can remain at the heart of these developments. Moreover, I trust the report provides new comparative insights which will assist the Chancellor and his City of London taskforce in their efforts to promote our financial services globally and to further boost the case for making Britain the location of choice for international business.

Michael Snyder
London
June 2006

Foreword

Chris Gibson-Smith
Chairman, London Stock Exchange

Equity markets are undergoing profound change. The development of complex trading strategies coupled with a step change in technological innovation has put serious pressure on traditional market structures. The response of exchanges will not only determine their future survival but the cost of capital available to their listed companies.

The decision at the London Stock Exchange in 2003 to overhaul its technology has enabled us to increase the speed of transactions, fuel liquidity and reduce costs for investors and companies alike. Our intention is that innovation and investment by us, and market participants, will create the most advanced exchange platform of any central market place, and will ensure that London reinforces its lead as the place to trade equities in Europe and, increasingly, globally.

Maintaining London's advantage is especially important as financial markets globalise and barriers to international investment reduce. As companies and investors access overseas markets with fewer and fewer restrictions exchanges must be able to offer the most competitive marketplace.

This report outlines many of our achievements in lowering the costs of listing and trading and in the provision of capital. It acknowledges that our cost of capital, both for IPO issuance and direct cost of trading is lower than our major rivals. It highlights that our standards of corporate governance are the best in the world and strengthen investor confidence in our Main Market. Furthermore, it underlines the success of AIM, the most successful growth market in the world, in offering unrivalled access to public equity capital at an earlier stage in a company's development cycle.

However, we must also be vigilant about future threats to London's competitive position. The report demonstrates, through the US experience with Sarbanes Oxley, that burdensome legislation can damage international competitiveness. The same is true of taxation. Although London has the lowest direct trading costs of all the exchanges in the sample, when Stamp Duty is added to the equation the picture is reversed. Stamp Duty is grit in the wheels of the UK market and the Government should take steps to abolish it.

We are delighted that this report highlights the progress we have made so far in delivering access to low cost capital for UK and international companies. Through technological advance and a focus on market integrity we are committed to strengthening further London's position as the world's capital market.

Chris Gibson-Smith
London
June 2006

Executive Summary

Oxera has been commissioned by the City of London Corporation and the London Stock Exchange (LSE) to conduct independent analysis of the costs of listing and raising capital in the London markets compared with other major financial centres. The study compares London's equity markets (the LSE's Main Market and the Alternative Investment Market, or AIM) with the other two major European stock exchanges (Deutsche Boerse and Euronext), and with the New York Stock Exchange (NYSE) and Nasdaq in the USA. Since the LSE provides for issuers that seek to raise equity or debt, the study also considers London's comparative position as a listing venue for corporate debt issues.

The comparative cost of raising equity in London

The European exchanges in 2005 raised more new money from initial public offerings (IPOs) and attracted more international IPOs than the US exchanges. The increase in European IPO activity was largely driven by activity on the LSE, in particular the AIM, which accounted for 52% of total European IPOs in the year. The LSE saw more IPOs than the US exchanges combined, and currently has the most active market in IPOs in the world.[1]

Moving beyond evidence on actual equity-raising decisions, this study provides evidence on the comparative costs of listing and raising equity on the different exchanges.

The comparative analysis focuses on the costs that drive a wedge between the net return required by investors and the cost of equity capital faced by companies, including both the initial costs incurred at the IPO stage (or in subsequent issues) and the ongoing costs.

Figure 1 The costs of raising equity capital

Costs at IPO stage

- direct costs
    - underwriting fees
    - professional fees
    - initial listing fees
    - other direct IPO costs
- indirect costs
    - IPO price discounts

Ongoing costs

- direct costs
    - regulation, corporate governance, professional fees
    - annual listing fees
- indirect costs
    - trading costs

Cost of equity capital

Source: Oxera.

[1] PriceWaterhouseCoopers (2006), 'IPO Watch Europe—Review of the year 2005'.

No data points are available where companies have simultaneously raised equity on all the markets considered in this study; thus, most of the analysis is based on an aggregate assessment of costs incurred by companies that have actually decided to raise capital in the markets.

In relation to IPO costs, the evidence suggests that issuing equity on the London markets is cheaper than on NYSE or Nasdaq, mainly because of the systematically higher underwriting fee charged for US transactions. London's position in terms of measurable costs is similar to that of Euronext and Deutsche Boerse.

- **Underwriting fees** differ significantly depending on listing venue. While they are similar for transactions on the European exchanges (3–4% on average), on US transactions underwriting fees are significantly higher (fees of 6.5–7% are most common). On average, therefore, IPO receipts are more than 3% lower in the USA than in Europe. Underwriting fee differences also apply to equity issues after flotation.

- Other direct IPO costs include the **legal, accounting and advisory fees**, as well as the marketing and PR costs. Taken together, these add another 3–6% for many issuers, but depend on issuer-specific factors such as the amount of funds raised. No evidence was available to suggest that there are significant differences in these costs between the listing venues, although interviewees noted that professional fees in London tend to be higher than in Frankfurt and Paris, but not as high as in New York. The higher legal and auditing costs in the USA were largely attributed to the costs of complying with the Sarbanes-Oxley Act (SOx).

- **Initial listing fees** constitute a negligible amount of the total cost of raising equity on all exchanges—in general less than 0.1% of the amount issued. Annual fees paid to maintain a listing are also negligible compared with other costs.

- **IPO discounting** can be a significant indirect cost (often referred to as 'money left on the table'). For the average IPO, first-day returns amount to 10–15% or more. Estimates differ markedly across time and companies, making a cross-market comparison difficult. Overall, there is little evidence of systematic differences in discounting across exchanges. Importantly, the higher underwriting fees on US transactions do not appear to be compensated by lower IPO discount levels.

The cost of raising capital in public equity markets is also affected by the ongoing costs facing companies and their investors. These include, in particular, the direct and indirect trading costs in secondary markets, which have a negative impact on share valuations and the cost of equity. Comprehensive data on direct trading costs (brokerage commissions and exchange fees) and indirect costs (liquidity as measured by effective spreads or market impact) for the different markets is not available. However, trading cost data collected by Elkins/McSherry during 2004 and 2005 suggests that:

- The direct costs of trading (brokerage commissions and fees) incurred by institutional investors differ significantly across countries. The direct trading costs, excluding stamp duty, were between 0.7bp and 3.4bp lower on the LSE than on the other exchanges examined in this study.

- The 'market impact' measure of indirect trading costs (i.e., effective spreads) suggests that, over the period, NYSE had the lowest costs, followed by Deutsche Boerse, Euronext (France), the LSE and Nasdaq.

- Overall, total trading costs incurred by institutional investors in the sample were lowest on the NYSE (23.5bp), followed by the LSE (25.5bp excluding stamp duty). Total trading costs in France and Germany are similar (27bp), with Nasdaq ranking behind (30.8bp).

Markets differ in their **regulatory and corporate governance frameworks**. The impact on the cost of raising equity capital can be both positive (compliance with better framework signals quality and is valued by investors) and negative (stricter standards impose greater costs on companies).

- The UK is ranked as the leading country in terms of corporate governance. Accordingly, a listing on the LSE's Main Market should deliver the greatest benefits in this respect, closely followed by the USA. The UK's corporate governance lead over Germany and France is larger, indicating that a listing in London may deliver higher valuations and a lower cost of equity along this dimension.

- The recent US corporate governance reforms as part of SOx have increased the costs of a US listing. This may have improved governance standards in the USA, but there is no evidence to date to suggest that the new regime delivers benefits beyond those that apply under the UK regime. The rise in US compliance costs has therefore increased the competitive position of the London markets.

In practice, specific companies can incur costs that are very different from the overall costs observed in the market, depending on their size, industry affiliation and country of domicile.

- **Size**—most of the costs associated with raising equity in public markets decline in proportion to the size of the issue.

- **Industry affiliation**—by choosing to raise capital in a market with a strong clustering of analyst and investor expertise in a particular industry, companies may be able to achieve higher valuations and reduce their cost of raising capital compared with other markets.

- **Country of domicile**—stronger cultural integration between the place of raising capital and the country of domicile is likely to reduce informational problems on the part of investors, resulting in lower costs associated with raising capital. For example, companies from countries that are English-speaking or that follow the more Anglo-Saxon legal and institutional frameworks may incur lower costs of raising equity in the UK or US markets than on Euronext or Deutsche Boerse. Similarly, company-specific financial and economic links with the host country can explain capital-raising and listing decisions for specific companies.

Listing corporate debt in London markets

The listing of corporate debt on exchanges is mainly a European phenomenon. The main reasons for the prominence of listing in Europe are fiscal and regulatory requirements, as well as client guidelines set by European institutional investors that restrict investment in unlisted securities. The exchanges with significant international debt listings are the LSE's Main Market and its newly created Professional Securities Market, the Luxembourg Stock Exchange and the Irish Stock Exchange.

Unlike in the case of equities, the geographic location of a listing venue for debt securities is of little importance to the cost of issuing corporate debt in Europe. This is because listing is largely de-linked from other parts of the capital-raising process as well as from debt trading, and because the few costs that are directly associated with listing are small.

- The European corporate debt markets are international, with most of the debt issued being in the form of Eurobonds and Euro-MTNs and simultaneously targeted at several pools of capital. Also, trading of corporate bonds is largely off-exchange, so trading costs do not depend on the geographic location of the listing venue.

- The geographic listing location therefore does not significantly affect the underwriting process and the ability to tap into different pools of capital; neither does it influence the nature of trading in the secondary markets. Rather, choice of listing venue is driven by the ease and speed of the listing process.

- Looking at the costs that are directly related to a listing venue, listing fees are negligible and very similar across exchanges. There is also no evidence to suggest that legal, accounting and other advisory costs differ significantly depending on the choice of listing venue.

Listing rules and other regulatory requirements may be an important consideration in the choice of where to list a particular debt issue, but the differences between the European exchanges do not appear large enough to have a material effect on the cost of issuing debt. Furthermore, the introduction of European Directives may further reduce any existing differences in regulatory requirements.

The City of London Corporation

The City of London is exceptional in many ways, not least in that it has a dedicated local authority committed to enhancing its status on the world stage. The smooth running of the City's business relies on the web of high quality services that the City of London Corporation provides.

Older than Parliament itself, the City of London Corporation has centuries of proven success in protecting the City's interests, whether it be policing and cleaning its streets or in identifying international opportunities for economic growth. It is also able to promote the City in a unique and powerful way through the Lord Mayor of London, a respected ambassador for financial services who takes the City's credentials to a remarkably wide and influential audience.

Alongside its promotion of the business community, the City of London Corporation has a host of responsibilities which extend far beyond the City boundaries. It runs the internationally renowned Barbican Arts Centre; it is the port health authority for the whole of the Thames estuary; it manages a portfolio of property throughout the capital, and it owns and protects 10,000 acres of open space in and around it.

The City of London Corporation, however, never loses sight of its primary role – the sustained and expert promotion of the 'City', a byword for strength and stability, innovation and flexibility – and it seeks to perpetuate the City's position as a global business leader into the new century.

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