

Leadership in a changing global economy:

The future of London's IPO market



London

Stock Exchange Group

“For companies seeking to raise capital, London remains the premier destination for ambitious businesses from the UK and around the world.

London offers access to an unparalleled pool of international capital, broad and deep advisory expertise, visibility alongside global peers and as a market, a track record of supporting companies, small and large, that is unsurpassed.”

Xavier Rolet, CEO of London Stock Exchange Group



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Introduction

The financial crisis has been set against deep transitions in economic power, accelerated by both the relative decline in Western economic power and the continuing rise of the new economic powers in the East. Emerging from this crisis, it is right to ask what London's role in tomorrow's global economy will be.

Unlike other international financial centres, London has developed by looking outward for opportunities rather than inward. Indeed, the very first shares issued in London were for a British company seeking trade routes with China. As well as our historic legacy, London's structural advantages are embedded. We have a time zone which enables us to trade simultaneously with the East and West, we use a language which is considered to be the business language of the world, and we act as a gateway into the European economy. London's role as a 'traditional' global financial centre has gradually led to the development of a virtuous circle of financial expertise. Today, London is characterised by a deep pool of capital, high standards of regulation and transparency, strong corporate governance, and a world class advisory and skills base.

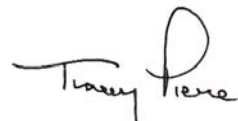
London's legacy as a 'traditional' financial centre does not mean that its prominence on the world stage is in any way diminished. In fact it is precisely the way London has developed which enables it to provide leadership in a changing global economy. Our openness to international markets – this ability to build relationships with new international partners – is London's single greatest strength. This internationalism is embedded in the way London

works and is what gives us an enduring competitive edge as the world recovers from financial crisis. Along with London's structural advantages, it will ensure London remains an effective venue for listing and capital raising, enabling companies from around the world to raise their profile on a global stage, and differentiate their offering from regional competition.

London's continued ability to attract companies from around the world to list demonstrates this internationalism. Today, the London Stock Exchange is the world's most international exchange with almost 3,000 companies from over 110 countries listed and traded on its markets¹. The continued strength of this capital market is vital, as a healthy market reduces the cost of capital for both large and small companies in the UK and abroad, helping them to create jobs and grow².

This paper is a call to action to the community of banks, advisers, investors and private equity firms, that support companies choosing London as their listing venue, to work together to show the world how strong the London market is. To do this, using new, previously unpublished data, the paper examines some of the issues that have been raised in the recent debate around London's IPO market, and makes practical suggestions for further improvement.

London can lead in our changing global economy and continue to provide a strong platform to support the growth of ambitious companies.



¹ The London Stock Exchange has the highest number of listed international companies in the world with 593 international companies admitted to our markets as of the end of September 2011.

² So far in 2011 companies on the Exchange have raised £12.8 billion in new issues.

Today, the London Stock Exchange is the world's most international exchange with almost 3,000 companies from over 110 countries listed and traded on its markets.





Executive summary

This paper is a call to action to the banks, advisers, investors and private equity firms, that play such important roles in attracting companies to list in London, to work together to show companies considering a listing, what London can offer them.

We hope the proposals outlined will help to form a consensus from which we can move forward and further build on London's success as a world leading listing venue.

This paper is split into two sections. The first section examines the issues that have been raised in the recent debate around London's IPO process. The second section examines how London's IPO market performs relative to its international competitors.

1. London's IPO process

Pre-IPO investor engagement and expectations

The issue. Some investors have argued that the limited opportunities they have to engage with companies and conduct research at an early stage in the pre-IPO process limits the confidence they have in companies and the likelihood of investment. But others have argued that they simply do not have the time to engage with the company until the management roadshow stage.

London Stock Exchange view. What is clear is that investors should have the *opportunity* to engage earlier with companies. There is a growing sense, expressed not just by investors but by banks as well, that the standard two to three week engagement window has become increasingly inadequate as the investor engagement and research process has developed and issuers have become increasingly international.

Way forward = more opportunities for extended and widened engagement with pre-IPO companies, which investors and the media are responsible for utilising. We support proposals that there should be more independent pre-IPO research³. We also suggest that there should be earlier and deeper engagement with a wider set of investors, especially on corporate governance. Fulfilling corporate governance expectations early in the process and being able to discuss corporate governance decisions with investors will give them a better understanding of, and confidence in the company, which could enhance the company's wider reputation, and its performance in the secondary market. Media expectations, which will in turn influence potential investors, should also be carefully managed.

Pricing and valuation

The issue. One of the most frequently discussed issues about any IPO process is the way IPOs are priced and valued – and in particular whether this leads to IPOs in London being traded below their issue price. This is driven in part by a lack of transparency in the process, and a concern that banks give companies unrealistically high valuations in order to win their business, and short term motivations determine the price that banks then set for IPOs.

London Stock Exchange view. Our analysis indicates that comments that more IPOs in London are trading below their issue price, and are priced either below or above range, compared to other financial centres, are unfounded. In seven of the last ten years, more than half of London IPOs were

trading at a share price above their offer price a year after they were floated; London has had the largest percentage of IPOs trading above their offer price compared to the New York Stock Exchange (NYSE) and the Hong Kong Stock Exchange (HKEx) since the financial crisis; and London IPOs are priced within range more consistently than those trading on either NYSE or HKEx.

Way forward = improved pre-IPO engagement. Although the data in this paper does not support the comments raised about IPO pricing and valuation in London, the *perception* that pricing in London is an issue needs to be addressed. By working to improve the pre-IPO process through the measures outlined above, London's IPO community can strengthen the environment for companies seeking to list.

³ Bank of America Merrill Lynch, EMEA Capital Markets, *A Set of Guiding Principles for IPOs*, 12 July 2011.

Size of IPO syndicates

The issue. It has been frequently argued that deal syndicates in London have grown in the last few years and these larger syndicates are more likely to hinder IPO success.

London Stock Exchange view. The analysis in this paper indicates that deal syndicates in London have not dramatically increased in size and are significantly smaller than in other leading financial centres.

Way forward = effective and responsive deal syndicates. The size of a deal syndicate should be appropriate to the size and requirements of the IPO. Syndicates should also be carefully constructed and managed to provide clarity of roles, leadership, and coverage.

Fee structures and incentives

The issue. It has been argued that banks are incentivised to care about the short term performance of the company they are bringing to market rather than its long term success, because of the way banks' fees are currently structured. Withholding banks' fees until the extent of a company's long term success can be measured has been suggested as a solution to this perceived short-termism.

London Stock Exchange view. As well as the short term performance of the company they are bringing to market, banks are also incentivised by longer term concerns such as the potential financial and reputational incentives resulting from a successful long term relationship between banks, companies and investor groups. Withholding banks' fees is not the right solution and could have damaging implications for the health of London's IPO market. It would also be unfeasible to determine the extent to which banks should be held responsible for the long term performance of a company. It is also worth noting that gross average bank fees in London are

consistently lower than on either NYSE or NASDAQ, and were the lowest of any major international centre last year. However, the concerns of investors about the motivations of banks for the pricing and valuation of IPOs should be addressed.

Way forward = more transparency on IPO fees. To ease the concerns of investors about the way banks are paid for bringing a company to market, there should be more transparency on fee structures. We recommend that London's IPO community considers two measures to be used as best practice. First, as a minimum, the band for banks' fees (including, where relevant, any incentive fee) should be published in the prospectus. This would increase transparency, but retain competitiveness, as the precise fee would not be disclosed. Second, as well as the amount banks are paid for bringing an IPO to the market, investors are also concerned about the criteria used to determine a bank's fee. The fee structure criteria could also be disclosed in the prospectus as best practice.

2. International context: the health of London's IPO market

The issue. It has been argued that London's market is suffering because more IPOs are 'pulled' here than elsewhere, and IPOs perform worse in London over the long term than in other centres.

London Stock Exchange view. In the first 9 months of 2011, 67 IPOs listed in London, more than any other major exchange, raising £12.8 billion. Over the last four years, the London Stock Exchange has had the lowest rate of withdrawn IPOs compared to our major competitors. And since the financial crisis, London has had the largest percentage of IPOs trading above their offer price compared to NYSE and HKEx. In addition, IPOs in London are priced within range more consistently than those trading on either NYSE or HKEx.

Way forward = take practical steps to support London as a world leading destination for companies to raise capital and create growth. London's continuing attractiveness as an international listing venue is not just important to market participants but to the UK economy as a whole. There is an opportunity for policy makers to support the IPO market by doing two things:

1. **Enable regulators to consider the UK's economic competitiveness.** There does not need to be a trade-off between strong regulation and competitiveness. Indeed strong regulation provides companies looking to list with confidence and stability. But for the UK economy, regulators must be able to take the UK's ability to compete internationally into account when developing regulation. Therefore, the UK Government should reinstate the requirement for financial services regulators to consider the UK's competitiveness in the new Financial Services Bill.
2. **Abolish Stamp Duty on shares.** The UK has the joint highest rate of Stamp Duty in the world with the Korea Exchange of 0.5 per cent. This high rate of Stamp Duty puts the UK at a competitive disadvantage. As a result of higher economic growth following enhanced investment in business, abolition of Stamp Duty would be revenue neutral to the Exchequer within the lifetime of a parliament⁴. It would increase the total amount of capital investment by up to £7.5 billion a year, and deliver a jump of up to 7.7 per cent in the stock market on the day abolition is announced⁵. By abolishing Stamp Duty on shares, the UK Government has a real opportunity to strengthen our economy.

⁴ KPMG, *Building a Sustainable Recovery*, June 2010, p.32. KPMG calculations found that the abolition of Stamp Duty could pay for itself within five years as increased GDP from greater investment would deliver an additional £3.2 billion in tax receipts, fully compensating for the loss of Stamp Duty.

⁵ Oxera Research, *Stamp Duty: its impact and the benefits of its abolition*, 2007 (updated in 2010), p.16; Institute of Fiscal Studies, *Stamp Duty on shares and its effect on share prices*, 2004, p.7.



London's IPO process



What is evident about the IPO debate in London is that some disagreement has built up between the different members of London's IPO community. Banks, investors and independent advisers have entered into a public war of words, questioning their respective role, behaviour and value in the process of bringing a company to the IPO stage. For companies, for the IPO community, and for our economy, it is important that these issues are addressed.

Due to the differing roles market participants play in the IPO process, a degree of structural conflict is inevitable. But four areas of the IPO process warrant further discussion:

- 1 Pre-IPO investor engagement and expectations
- 2 Pricing and valuation
- 3 The size of deal syndicates
- 4 Fee structure and incentives

This section outlines and discusses the issues raised by members of London's IPO community about the process involved in bringing a company to market, and makes practical suggestions for addressing them.



1. Pre-IPO investor engagement and expectations

‘...when there are so many people running a roadshow it is difficult for the directors to be in so many places. This means we do not get the dialogue we need with them, don't have the clarity on the business and lose the confidence to invest in the IPO’

Peter Lees, Head of UK equities at F&C Investments.

During the pre-IPO process, investors have the opportunity to engage with the company and conduct research. In doing so, investors can build up a picture of the company and familiarise themselves with its management and strategy.

A common observation about London's IPO process is that opportunities for investors to engage with the companies and conduct research at an early stage in the pre-IPO process are too limited. Limited engagement can result in investors feeling that they do not have a clear picture of the company, and therefore lack the confidence to invest. Investors have expressed a preference for getting to know companies at an early stage rather than leave the research process to a single meeting. They have suggested that such meetings could be used to establish a framework for valuation, possibly by discussion of an appropriate peer group.

There is also a risk that limited pre-IPO investor engagement does not enable investors to fully understand the company's corporate governance arrangements. A public company needs to consider the corporate governance requirements as set out in the UK Corporate Governance Code and comply with the Code, or explain why they have not. As noted in *A guide to listing on the London Stock Exchange*, ‘it is typically necessary to appoint new members to the board who are independent and to form new committees (e.g. audit and remuneration)’⁶. Directors often want to be involved in the IPO process at an early stage and members of the deal syndicate will often recommend potential board members. Unfulfilled investor expectations on corporate governance could be potentially damaging for the performance of the IPO in the secondary market and the company's wider reputation.

The extract on the right summarises the opportunities investors have to engage with the company during the pre-IPO process. In practice, the main opportunity for investors to engage with the company is not until the management roadshow, which is typically held two to three weeks before flotation.

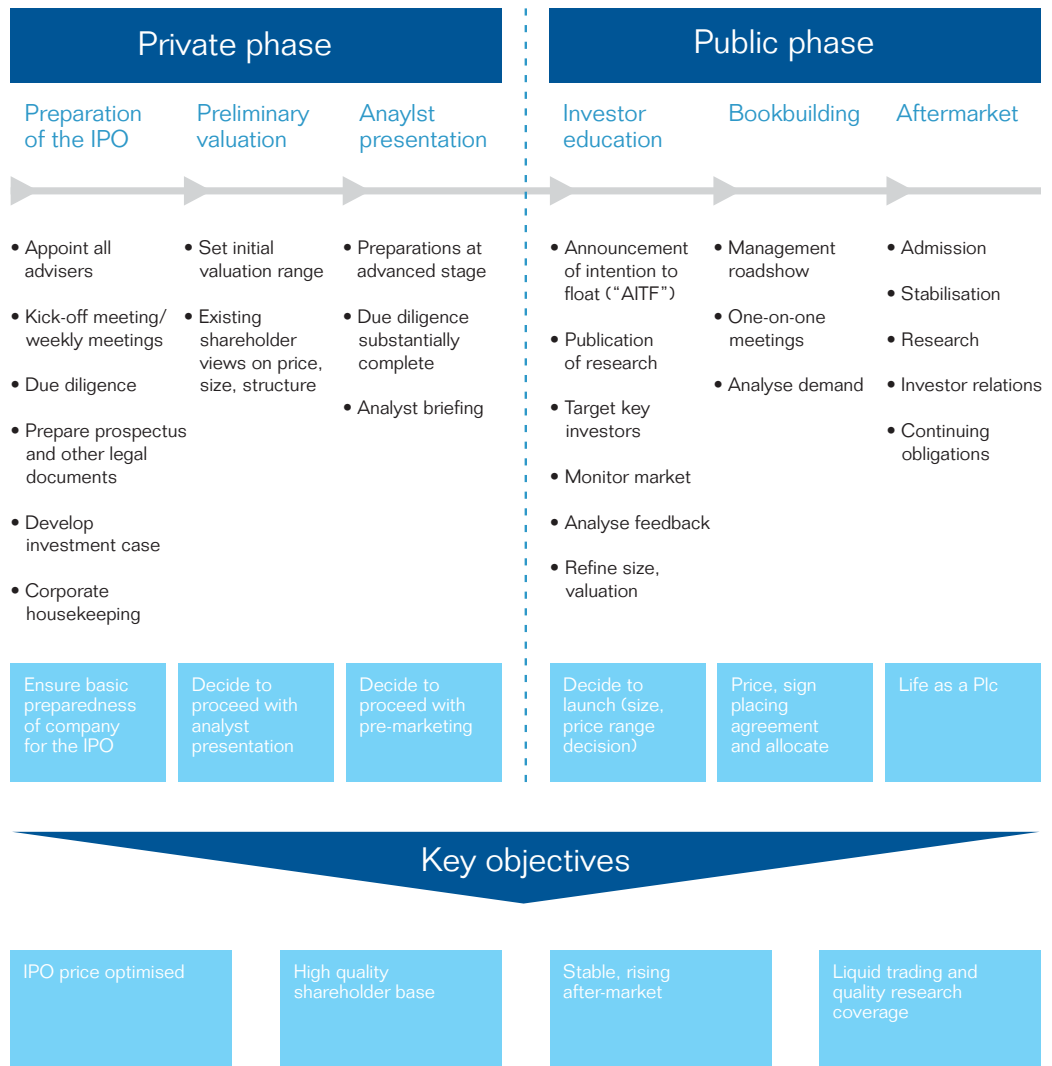
IPO marketing and opportunities for investor engagement in the pre-IPO process

- 1 Syndicate analyst research and the process to publication.** The bookrunners' research analyst will write detailed research notes on the company to educate investors before the transaction. The company's management team typically presents to the syndicate analysts early on in the preparatory process. Although investors will produce their own research, the bookrunners' report will influence their investment decisions.
- 2 Initial meetings with potential investors ('pilot fishing').** These meetings are organised by bookrunners to introduce the company to a select group of investors in order to get a sense of how the market will assess and value the company before the transaction is publicly launched.
- 3 Announcement of the intention to float.**
- 4 Investor education.** Investor education is conducted by the bookrunners who will typically book a series of investor meetings in different regions to educate them about the company. The feedback from this exercise will be used to set a price range for the shares that will be offered in the IPO.
- 5 Management roadshow.** The company's management will tour different regions to meet a significant number of investors (usually over a two week period) to explain the business.

A guide to listing on the London Stock Exchange, p.63–64.

⁶ London Stock Exchange *A guide to listing on the London Stock Exchange* 2010 – UBS Investment Bank.

The pre-IPO process⁷



The investor engagement and research process has developed with market practice, and the time frame has lengthened partly due to more instances of international marketing. However, there is a growing sense, expressed not just by investors but by banks as well, that this engagement window has

become increasingly inadequate. In determining the right way forward on this issue, it is important to balance the need for earlier investor engagement with the need to protect the confidentiality of the IPO before it is publicly announced.

⁷ A guide to listing on the London Stock Exchange, 2010, p.26.



Opportunities for improvement

We support the following proposals, some of which have been put forward by market participants, to extend and widen investor engagement with pre-IPO companies:

More independent research. We support proposals that there should be more independent pre-IPO research. It is for London's IPO market to determine how best to facilitate this, but one suggestion is that research analysts from non-syndicate banks and brokers should be given access to the analyst presentation, especially for larger deals. By doing this, institutional investors have the opportunity to see research from banks and brokers that are not in the IPO syndicate. This could go some way to giving investors more insight into the pricing of an IPO⁸.

Earlier, deeper, and wider investor engagement. Although not all investors would necessarily find earlier engagement desirable, it is important that investors are at least given this option. We support proposals for deeper and more active engagement with companies. This engagement should include conversations about management, strategy and pricing. Issuers, banks and investors all have a key role to play in ensuring that this works well. We would advise banks to consider the appropriate range of investors at an earlier stage, and to provide clear guidance to the company on the investors who

have previously invested in similar IPOs. We would also advise investors to take full advantage of opportunities to engage with the companies at an earlier stage. The company should be fully prepared to engage with investors, using a clear communication plan, business strategy, prepared investment objectives and appropriate financial reports.

Careful management of media expectations. We recommend that as well as investor expectations, media expectations need to be carefully handled so that the IPO is appropriately positioned when the deal is made public. A regular stream of announcements and updates will help to maintain momentum and help to keep the investment opportunity at the forefront of investors' minds.

Engage with investors on corporate governance at an early stage. Fulfilling corporate governance expectations early in the process and being able to discuss corporate governance decisions with investors will give investors a better understanding of, and confidence in the company. This could enhance the company's wider reputation and its performance in the secondary market. Companies should provide potential investors with explanations of their chosen governance structures and the reasons for any changes, during the pre-IPO process. It may also be beneficial for non-executive directors, particularly the board chairman, to participate in the investor roadshows.

⁸ Bank of America Merrill Lynch, EMEA Capital Markets, *A Set of Guiding Principles for IPOs*, 12 July 2011.

2. Pricing and valuation

One of the most frequently discussed issues about any IPO process is the way IPOs are priced and valued – and in particular whether this leads to IPOs in London being traded below their issue price.

The price of an IPO and its long term performance are the result of two key factors: (1) an effective pre-IPO process; and (2) the macro-economic and other extrinsic factors which affect the deal. The second aspect means that price certainty can never be absolute, and undoubtedly London along with other financial centres has been affected by market volatility in recent years.

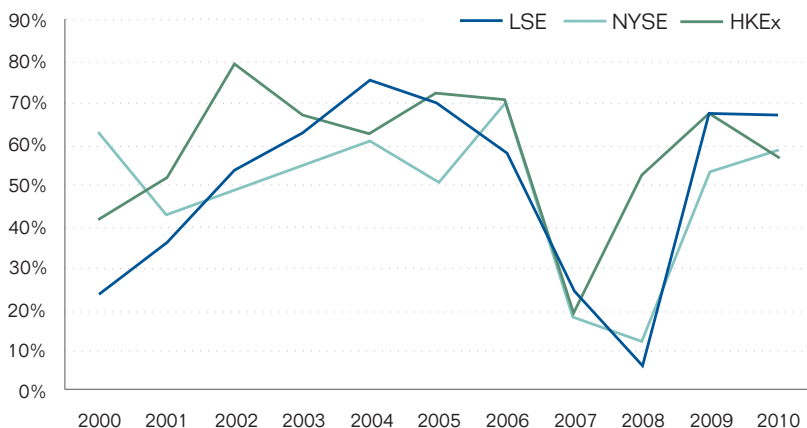
Yet the issue about pricing and valuation has been driven in part by a lack of transparency in the IPO process, and a concern that banks give companies unrealistically high valuations in order to win their business, and short term motivations determine the price banks then set for IPOs. It is concerning that this belief appears to be widespread among investors. A recent survey indicated that as much as 95 per cent of investors either do not trust banks when they are pricing and allocating IPOs, or want more transparency from them⁹.

It can be argued that banks' management of companies at the IPO stage is not wholly incentivised by short term price. They will in most instances retain relationships with the company,

⁹ *Financial News*, 4 July 2011.

¹⁰ Source: Dealogic.

Companies' share price above offer price after one year¹⁰



Bank of America Merrill Lynch recently set out the considerations it makes when pricing an IPO:

'The bookbuilding process in the IPO is an exercise in price discovery ... The indicative price range announced at the beginning of bookbuilding is used to guide investors as to the levels at which issuers/vendors would be prepared to sell shares. Companies should recognise that they may or may not need to float at a discount to their publicly-listed peer group. The level of discount, if any, that issuers/vendors will need to factor in at IPO pricing will depend on a number of factors including: (a) market conditions at the time of flotation; (b) numerous issuer-specific factors, including proximity of public peer group to the issuer, operational/financial track record of the issuer and any specific issuer/sector/geo-political risks; and (c) size of issuer and prospective free-float and aftermarket liquidity'.

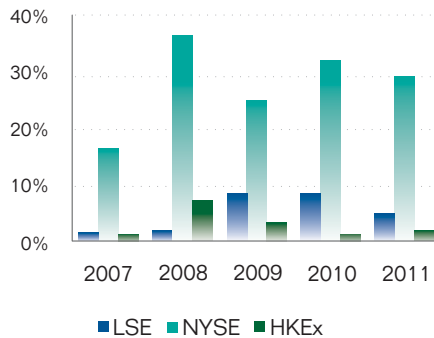
A Set of Guiding Principles for IPOs, 12 July 2011

and will want to see an IPO which affords them continued exposure to that economic growth.

But is it really true to state that IPOs in London are trading below their issue price? Contrary to this perception, London Stock Exchange analysis shows that in seven of the last ten years, more than half of IPOs were trading at a share price above their offer price a year after they were floated. Also, as the graph on the left indicates, London has had the largest percentage of IPOs trading above their offer price compared to NYSE and HKEx since the financial crisis.

As well as IPO performance after a year, IPOs on the London Stock Exchange are priced within range more consistently than those trading on either NYSE or HKEx. In 2010, one in seven IPOs trading on NYSE was priced above range whilst none were priced above range in London. So far in 2011, 30 per cent of NYSE IPOs were priced below range compared to 4 per cent in London. On average since 2007, the London Stock Exchange has had a smaller proportion of IPOs priced *below* range than those listing on NYSE.

Proportion of IPOs priced *below* range by financial centre: 2007 to 2011¹¹



Proportion of IPOs priced *above* range by financial centre: 2007 to 2011¹²



From this data, it is evident that the comments that more IPOs in London are trading below their issue price, and are priced either below or above range than elsewhere, are unfounded. It also indicates that price ranges in London tend to be more correctly assessed as a result of continuous review during an effective price discovery process. The analysis indicates that this practice may not be as prevalent in other centres, as many IPOs are missing their initial price range.

But even though it is unsupported by this dataset, the *perception* that pricing in London is an issue needs to be addressed.

Opportunities for improvement

Improve pre-IPO investor engagement.

By implementing the proposals contained in the previous section, such as more independent research, earlier and deeper engagement with a wider set of investors, and managing media expectations, London's IPO community can address the perception that the pricing of IPOs is inaccurate. Banks, investors and issuers all have a role to play in ensuring that this price discovery process is effective and optimal.



¹¹ Source: Dealogic.

¹² Source: Dealogic.

3. The size of IPO syndicates

Having made the decision to list, a company will appoint either a single bank (bookrunner) or a syndicate formed of banks to underwrite the sale of its shares. As well as acting as the underwriter,

the bank or syndicate of banks, will provide advice and help to the company to ensure that all legal requirements are met through the IPO process¹³.

Key players in the IPO process¹⁴



¹³ Bank of England, Quarterly Bulletin Q1 2011, p.15.

¹⁴ A Guide to Listing on the London Stock Exchange, 2010, p.10.

One of the most commonly cited problems with the IPO process expressed primarily, but not exclusively, by investors, is that bank syndicates have grown in size and this has a negative effect on the success of IPOs.

The criticism of larger syndicates is threefold. First, larger syndicates are seen as more challenging for the pre-IPO company to manage and for investors to communicate with. Second, the more banks there are in a syndicate, the further the syndicate's influence can extend. This extended influence can reduce the availability of independent research on pre-IPO companies. Third, the level of risk (both financial and reputational) for each bank in the syndicate decreases as the number of banks in the syndicate grows. The more widely risk in the syndicate is spread the less incentive each bank in the syndicate has to achieve a successful IPO for the company. This reduced risk by individual members of the syndicate can have the effect of lowering the level of investor trust in the syndicate as a whole.

This third concern has been supported by the Bank of England and to an extent by some banks¹⁵. But although some banks acknowledge the need for careful management of larger syndicates, they have pointed out that the decision about how many banks should form a syndicate rests with the issuer and with the vendors. Bank of America Merrill Lynch

(BAML) recently noted that 'certain circumstances may militate against smaller syndicates as in the case of privatisations or jumbo deals'¹⁶.

Data on the size of deal syndicates varies between sources. According to the Bank of England, the average number of banks participating in a syndicate in the UK has almost doubled since 2008, rising from two to almost four in 2011¹⁷. Dealogic data suggests that in 2011, there was an average of almost five banks in a syndicate compared to an average of two banks in 2008. But both these sources should be treated with care, as they include the unusual syndicate which handled the IPO of Glencore. This syndicate comprised 23 banks, which, if included, skews the overall average syndicate size. Excluding Glencore, Dealogic data shows that there was an average of three banks in London IPO deal syndicates in 2011.

The graph below shows the average IPO deal syndicate size by major international exchange for every year since 1999.

There are two striking findings from this graph. First, if the Glencore IPO syndicate is excluded, the size of deal syndicates in London has stayed roughly the same for the last ten years, indicating that the perception that syndicates in London are growing is a myth rather than a reality.

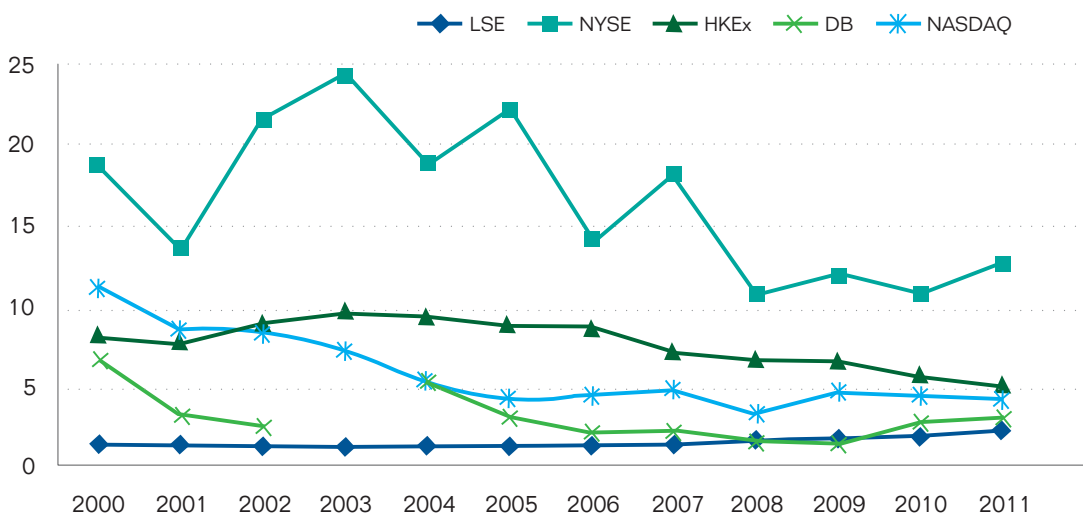
¹⁵ In a recent quarterly report, the Bank of England argued that as a result of the reduced potential for reputational loss of individual members of a syndicate, their incentives to ensure that an IPO succeeded in volatile conditions is reduced. Bank of England, *Quarterly Bulletin Q1 2011*, p.16.

¹⁶ Bank of America Merrill Lynch, *A Set of Guiding Principles for IPOs*, 12 July 2011.

¹⁷ Bank of England, *Quarterly Report Q1, 2011*, p.16.

¹⁸ Due to its large size, the Glencore IPO syndicate distorts the average syndicate size in London in 2011. Even if Glencore is included, it only raises the average size of a deal syndicate in London to 4.77 banks – still significantly lower than the NYSE or HKEx figures. Source: Dealogic (2003 data for Deutsche Boerse is unavailable).

Average IPO deal syndicate size by major international exchange¹⁸





‘Investors and issuers have the right to expect leadership and strong advice from banks at the top of a deal. When there are too many in the lead group, it creates opportunities for some to shirk accountability’

Tim Harvey-Samuel,
head of equity capital
markets for EMEA,
Citigroup

Second, even including Glencore, the size of syndicates in London is significantly lower than deal syndicates for IPOs listing on either NYSE or HKEx. In fact, the average number of banks in a NYSE syndicate has been more than double the number of banks in London syndicates for the last ten years.

There could be many reasons for the larger size of NYSE IPO syndicates. Technology IPOs, frequent in New York, tend to rely on more specialist syndicate members to provide analyst support. Analyst coverage during the pre-IPO process in the US is generally not as extensive as in the UK, so more banks are recruited to the syndicate to gain better coverage. Lastly, larger fees in the US may make it easier to attract more banks to join syndicates.

Some market participants have argued that that it is not the size of the overall syndicate, but the increased number of bookrunners (banks leading the syndicate) working on a deal, that has resulted in a lack of leadership in syndicates.

Undoubtedly the number of bookrunners in London and elsewhere has increased, especially since the financial crisis, but these increases are still small. Between 2006 and 2010, the average number of bookrunners working on London IPO deals grew from 1.7 to 2.8. But despite this small increase,

there are still fewer bookrunners in London than in New York – the number of bookrunners working on NYSE IPO deals has risen from 2.0 to 3.4 within the same period. In Hong Kong there was an average of 2.6 bookrunners in 2010.

So, if syndicates in London have not grown, and there are fewer bookrunners in London syndicates than in other international markets, why do we have a widespread perception to the contrary? We believe that the comments on syndicates and bookrunners maybe symptomatic of some investors feeling alienated from the wider pre-IPO process. The less involved investors are in the pre-IPO stages, the less likely it is that they feel in a position to make confident investment decisions about a company.

A possible solution to the perceived problem could be to impose an upper limit on the number of banks in a syndicate. However, in practice this would be problematic. Different sized IPOs will have differing geographic, sectoral or other challenges which require greater or lesser coverage by the syndicate. This varied nature of a company's IPO requirements makes it difficult and potentially detrimental to prescribe limits on the size of syndicates. In addition, as the size of syndicates in London has not grown significantly, imposing an upper limit would not have a significant impact.

Opportunities for improvement

Instead of limiting syndicate size, our proposals focus on measures to improve investor confidence in syndicates through encouraging them to function in a clearer and more transparent manner:

The size of a deal syndicate should be appropriate to the size and requirements of the IPO. When constructing its syndicate, a pre-IPO company should fulfil its needs with the smallest number of banks to begin with, adding more banks only when there is a specific, practical reason to do so. Each bank added should have a clear, transparent reason for being involved in the deal. There is no strict rule that smaller syndicates always function better than larger ones, but there is also no benefit in having a large syndicate for the sake of it.

Syndicates should be carefully constructed and managed to provide clarity of roles, leadership, and coverage. Careful management of syndicates is especially important for larger syndicates. Consideration could be given by the pre-IPO company to appointing a single lead member of the syndicate. This member could channel advice from other members of the syndicate to the company and to other market participants. In doing this, the company would receive a single channel of clear advice, and other market participants, especially investors, would have a clear first port of call to contact about the IPO. Indeed there is already a precedent for a bookrunner taking a lead role in syndicates with multiple bookrunners. In some instances, a syndicate may appoint global coordinators who intermediate with the company.

The following advice for companies selecting their syndicate members was offered by UBS Investment Bank in *A guide to listing on the London Stock Exchange*:

In order to select the right bookrunners for the IPO, many companies and their shareholders will invite a number of potential candidates to a formal 'beauty parade' (so that they can hear the views of each and make an informed decision on the back of that information). This process has become more common in recent years and is well advised for any company considering an IPO. In certain circumstances, an independent adviser may be hired to assist in the process of selecting bookrunners for the offering.

Some of the criteria that can be used to assess the candidates are listed below, but this should not be considered prescriptive and each company will look for different qualities in its IPO bookrunners:

- quality of project team and commitment
- relevant credentials and distribution capabilities
- quality of research analyst and market credibility
- industry knowledge, understanding of the issuer and its equity story
- ability to support the issuer in the after-market
- views on valuation and positioning
- proposed levels of fees
- company's relationship/rapport with the adviser

4. Fee structures and incentives

Another discussion point within London's IPO community has been the way banks in the IPO syndicate are incentivised. The main argument is that the current fee structure incentivises banks to care only about the short term success of the IPO, rather than its performance over the longer term¹⁹. As well as fee structure incentives, investors have also argued that there is a lack of transparency over the way fees are paid, which reduces investor trust in the banks' motivations during the IPO deal²⁰.

The fee arrangements for the banks involved in the IPO vary considerably. However in broad terms, banks will typically receive their main fee at closing and an incentive fee (if applicable) within the initial months following the flotation.

Viewed in isolation, it is legitimate to argue that the short length of time after the company has floated and before the banks are paid, could incentivise banks to focus on the short term success of the IPO. But there are other factors to consider before proposing any action.

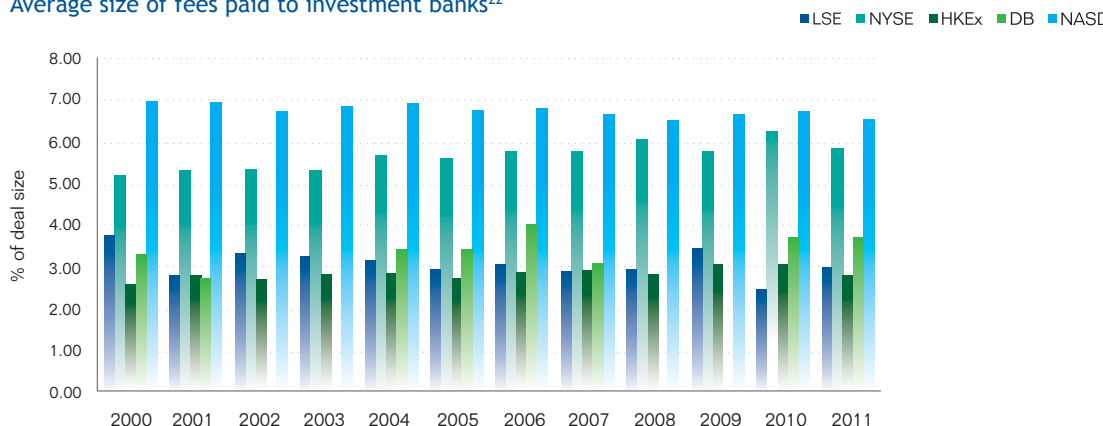
First, the bank's fee is typically paid for the months, and in some cases the years, of work it has undertaken during the pre-IPO process. In most cases, the fee is paid mainly for this pre-IPO work rather than the success of the IPO after it has floated. It should also be noted that incentive fees are rarely explicitly linked to secondary market performance.

Second, maintaining the bank's reputation limits its willingness to under-price IPOs. Whilst there could be an incentive for banks to provide a higher valuation of the company in order to win the deal, the more inaccurate their original valuation appears once the company has been listed, the less likely they are to win future IPO business. It is not the role of the bank to under-price or over-price an IPO, but 'to find an optimal price at which issuers/vendors will agree to sell and investors will agree to buy ...'²¹.

Third, banks have a long term incentive to maintain a positive relationship with both the company and investors. For example, if the bank is perceived to have done a good job and the IPO has been successful, the company will be more likely to consider the bank for future work such as M&A and advisory activity.

Although it is the structure of bank fees rather than their size which primarily concerns investors, it is worth noting that gross average fees in London are consistently lower than either NYSE or NASDAQ, and were the lowest of any major international exchange last year. The graph below shows that in 2010, the gross average fee in London was 2.45 per cent of the deal size, compared to 6.24 per cent on NYSE and 6.71 per cent on NASDAQ.

Average size of fees paid to investment banks²²



¹⁹ *Financial News*, 18 July 2011.

²⁰ For example, a survey conducted by *Financial News* found that 95 per cent of investors either don't trust banks when they are pricing and allocation IPOs or want more transparency from them. *Financial News*, 4 July 2011).

²¹ Bank of America Merrill Lynch, *A Set of Guiding Principles for IPOs*, 12 July 2011.

²² Source: Dealogic.

The potential financial and reputational incentives resulting from a successful long term relationship between banks, companies and investors go part of the way to balancing out the short term incentivisation of the IPO fee structure. However, it has not been enough to address all investor concerns.

It has been suggested that the UK Government should legislate to withhold a portion of banks' fees after the IPO of their client company, and only release this portion after a period of months or even years when it can be determined whether or not the flotation has been a success²³. The aim of withholding fees for a set period would be to incentivise banks to consider the longer term success of the IPO, rather than just the price achieved in the three month period after flotation.

A similar idea to incentivise banks to take a longer term view of the success of an IPO has been using the discretionary element of a bank's fee. The criteria for awarding the discretionary fee could be devised according to what the company believes constitutes a successful long term flotation. By doing this, the company could reward performance while reinforcing what it believes to be the right behaviours.

The aim of proposals to withhold a portion of a bank's fee or use the discretionary fee would be to ensure that banks consider the longer term success of the company's flotation. Although such proposals could narrow the perceived divide between the interests of banks and investors, deeper analysis suggests that there would be practical problems.

First, it is not clear how, or by whom, the success of an IPO and therefore the banks' fee should be assessed. For example, if an IPO fails after six months due to macro-economic factors such as a market crash or political events, could this justify withholding the bank's fee? Although of course if it was felt that a company was poorly equipped to weather a market crash due to an inadequate

corporate governance structure for example, could it be argued that this was the bank's responsibility to address during the pre-IPO process – at least to some degree? But the question would still remain about who would assess this and the methods they would use.

Second, tying a bank to the long term success of an IPO could result in banks being less willing to take on smaller, less diversified companies. This in turn could have a negative effect on the ability of these smaller companies to raise capital and create growth through the use of equity.

Third, banks may encounter compliance issues if activities following pricing, such as stabilisation and market making, were deemed inappropriate in the context of an incentive fee based on post IPO performance.

Fourth, if banks view the requirements on fee structures as overly prescriptive they could encourage IPOs to list in other financial centres. This could hinder the UK's ability to compete as a global financial centre.

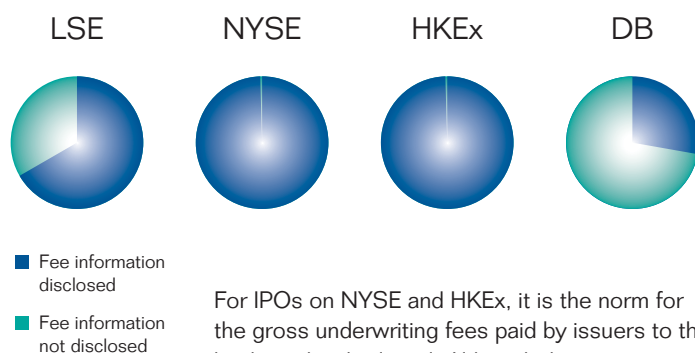
Finally, if the long term success of an IPO was a determinant of the discretionary element of a bank's fee, banks may be incentivised to raise other fees to mitigate the commercial risk, in the event that the IPO was not perceived as a success. Banks may also be incentivised to under-value companies at the IPO stage to make it appear that the price had risen over time and that the IPO had performed well.

Instead of withholding fees, BAML have proposed that 'there should be full and accurate disclosure in the prospectus of fees paid to underwriters (and adviser(s)), if any. In particular, there should be full transparency on discretionary fees paid for 'performance' or as an 'incentive', including the criteria to be applied in determining when and how much of such additional fee will be payable'²⁴.

²³ *Sunday Times*, 3 July 2011.

²⁴ Bank of America Merrill Lynch, *A Set of Guiding Principles for IPOs*, 12 July 2011.

Proportion of fees disclosed by companies at IPO stage



For IPOs on NYSE and HKEx, it is the norm for the gross underwriting fees paid by issuers to their banks to be disclosed. Although there are no such rules in the UK, over 60 per cent of companies listing on the London Stock Exchange still publish these fees²⁵.

This raises the question of whether it should be compulsory for companies in the UK to publish the fees they pay their banks. This is a serious suggestion, and warrants careful consideration. On the one hand it would undoubtedly make the IPO process more transparent and ease investor concerns. But on the other hand, there could be a risk of reducing competitiveness. In the US, gross spreads of fees on moderate-size IPOs began to cluster at seven per cent in the late 1980s and early 1990s. However, as there was no change in the disclosure requirements during that period, it cannot be assumed that this clustering was a result of the disclosure rules.

Opportunities for improvement

Disclosure of fee band as best practice to improve fee transparency and retain competitiveness. Instead of disclosing an exact fee, it may be more prudent to disclose a fee band. This would give investors an indication of the fee but would not hinder competitiveness as the precise fee would not be disclosed. But as the criteria determining a bank's fee is arguably as important as the size of the fee itself, an additional proposal is to disclose the criteria for awarding fees in the prospectus.

²⁵ Source: Dealogic.





International context:

the health of London's IPO market





Geo-political and macro-economic factors, such as fiscal structures, can have a significant impact on a company's decision to list.

This section assesses the performance of London relative to other international financial centres, focusing on three key areas:

- 1 The recovery of London's IPO market following the financial crisis, relative to that of other international IPO markets
- 2 Whether it is true to say, as has been widely reported, that more IPOs get withdrawn in London than in the US, and other markets
- 3 London's future as an international IPO market



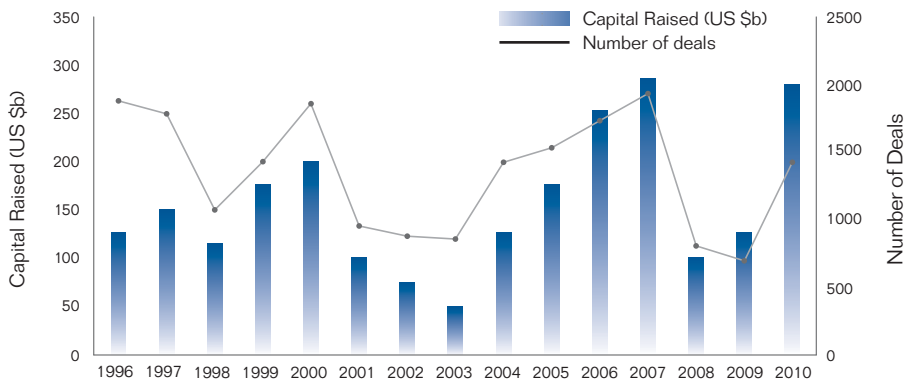
1. Global IPO markets: recovery from crisis

The global financial crisis did not just affect London's IPO market, it affected the global IPO market.

During the crisis, the number of companies listing on exchanges plummeted. In 2007, there was a total of 2,014 IPOs listing globally that raised USD 295

billion²⁶. But by 2008, this had reduced to 769 raising just USD 96 billion²⁷. Although the global IPO market has not yet returned to pre-crisis levels, it has made a strong recovery. In 2010, 1,393 IPOs listed globally raising USD 284.6 billion²⁸.

Global IPOs by number and capital raised by year²⁹



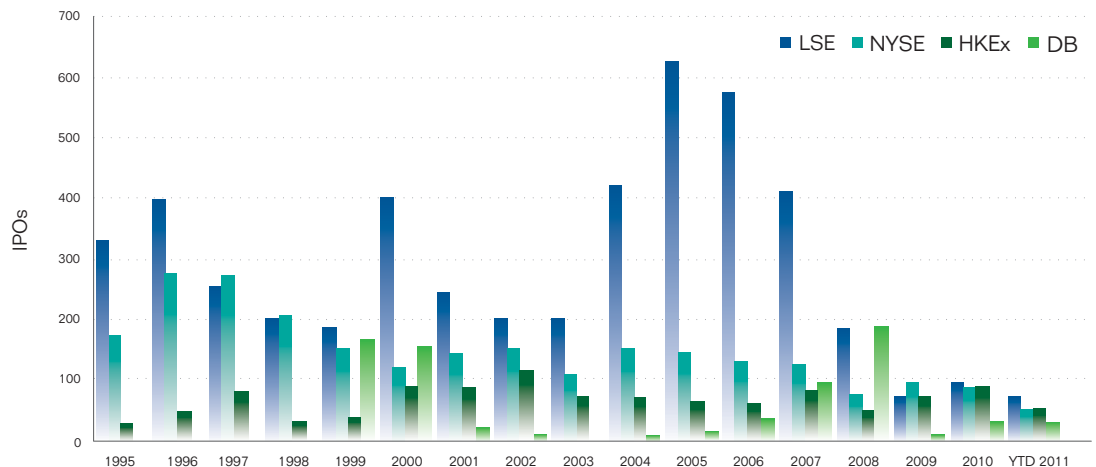
The London Stock Exchange was not immune to the effects of the financial crisis. In 2007, 269 IPOs listed on the Exchange, raising over £26 billion at admission. By 2009, the number of IPOs listed on the Exchange had fallen to 22, raising just over £1.5 billion.

But following the crisis, London's IPO market has made a strong recovery. In 2010, 95 IPOs listed on

the Exchange, raising almost £10 billion. In the first nine months of 2011, 67 IPOs have listed, more than any other major exchange, raising £12.8 billion.

The outlook also remains positive, as the pipeline of companies planning to list in London over the coming months and years remains strong, particularly from the UK and emerging, high growth international markets.

London Stock Exchange is a global leader in IPOs



²⁶ Ernst and Young, *Global IPO Trends Report 2011*, p.3.

²⁷ *ibid.*

²⁸ *ibid.*

²⁹ Adapted from Ernst and Young, *Global IPO Trends 2011*, p.3.

2. IPOs withdrawn

There have been concerns expressed in the media that the rate of IPOs being cancelled or put on hold in Europe is higher than elsewhere, and that this is reducing confidence in European capital markets.

As this paper is about London's IPO market, this section will focus on the number of IPOs which did not go ahead in London (rather than Europe as a whole).

'Too many IPOs are having to be pulled or are trading poorly. It is impacting London as a financial centre.'

Financial Times,
18 July 2011

Before exploring the rates of IPOs that have been withdrawn, it is important to note that there is a difference between a company fully prepared to list being *failed* by a *flawed* pre-IPO process, and a company which is not yet fully equipped to list being *revealed* through a *strong* IPO process. Factors such as poor corporate governance, management or strategy may emerge during the pre-IPO process and compel the company to reconsider its listing. In other words, the rate of postponed IPOs is not a straightforward indication of the strength or weakness of an IPO market itself, it could also be an indication of the suitability of a particular company seeking to join a market.

The table below illustrates the number of planned and executed IPOs for the London Stock Exchange as well as three of its competitors; NYSE, HKEx and Frankfurt.

The most striking finding from the table below is the difference between the perception and the reality regarding the rate of IPOs which do not proceed to list in London, compared to other IPO markets. There is a perception that London has a relatively

high rate of withdrawn IPOs, however, analysis reveals that the opposite is true. Over the last four years, the London Stock Exchange has had the lowest rate of postponed IPOs compared to our major competitors with 14.3 per cent of IPOs being withdrawn compared to 32.3 per cent from NYSE. The percentage of aborted IPOs in Hong Kong and Frankfurt are also higher than in London.

Although many issuers do not disclose the reason for cancelling their IPO, out of those who do provide reasons, by far the most common reason given is 'market conditions'. These market conditions could be a decline in expected market returns, cyclical volatility or volatility.

Of the 12 London IPOs withdrawn in 2011, 9 disclosed that 'market conditions' was the motivation. Of the 43 London IPOs withdrawn since 2008, 30 cited market conditions as the reason, 7 did not provide a reason, and the remaining 6 gave different reasons specific to their companies³⁰.

Between 2008 and 2011, 171 IPOs on NYSE, HKEx and Frankfurt did not proceed, 133 as a result of market conditions, and 13 of them due to acquisitions³¹.

The frequency with which market conditions is cited as the reasons for cancellation, compared to other reasons, suggests that macro-economic factors have the strongest impact on IPOs, compared to other issues, including the IPO process.

Proportion of IPOs executed: 2008–2011³²

Year	LSE			HKEx			Frankfurt			NYSE		
	Withdrawn	Listed	Withdrawn IPOs (%)	Withdrawn	Listed	Withdrawn IPOs (%)	Withdrawn	Listed	Withdrawn IPOs (%)	Withdrawn	Listed	Withdrawn IPOs (%)
2008	11	73	14	15	27	36	6	8	43	24	20	55
2009	1	22	5	3	58	5	3	5	38	23	44	34
2010	19	95	17	13	77	14	5	17	23	34	99	26
2011 ^(YTD SEPT)	12	67	15	12	44	21	4	12	25	29	68	30
Total (%)	43	257	14.3	43	206	17.3	18	42	30.0	110	231	32.3

³⁰ Source: Dealogic.

³¹ Source: Dealogic.

³² Dealogic and LSE calculations (statistics include growth market IPOs).

3. Opportunities for the UK Government to enhance the international competitiveness of London's IPO market

London's attractiveness as a global listing venue is not just important to market participants, but to the UK economy as a whole. The direct advantages of a healthy IPO market to the UK economy include; more efficient capital raising and cheaper access to finance, enhancing the ability of companies in the UK and abroad to create jobs and grow; an enlarged hub of financial expertise; increased tax revenues; and an enhanced diplomatic presence for the UK on the international stage.

There is an opportunity for the UK Government to help attract more companies to list in the UK by taking two measures: (1) Re-inserting the requirement for financial services regulators to consider the UK's competitiveness; and (2) Abolishing Stamp Duty on share transactions:

Reinsert the requirement for financial services regulators to consider the UK's competitiveness

The issue. Currently when regulating, the UKLA must have regard for "the international character of capital markets and the desirability of maintaining the competitive position of the United Kingdom"³³. In other words, it must consider how regulation affects the competitiveness of the UK's capital markets. The UK Government's current shake-up of UK financial services regulation means that it will no longer have to consider this.

London Stock Exchange view. There does not need to be a trade off between strong, effective regulation and being competitive. Indeed, strong regulation provides companies looking to list with confidence and stability. Retaining a regulatory system able to consider the attractiveness of the UK's capital markets, whilst ensuring financial stability, is an important way to attract more companies to list in London and ultimately to strengthen our economy.

Way forward = reinstate the requirement for financial services regulators to consider the UK's competitiveness. We would like the UK Government to reinstate the requirement for financial services regulators to consider the UK's competitiveness in the new Financial Services Bill.

Abolish Stamp Duty on share transactions

The issue. The UK has the joint highest rate of Stamp Duty on shares in the world (with the Korea Exchange) of 0.5 per cent³⁴. This high rate of Stamp Duty puts the UK at a competitive disadvantage. In fact, of major world stock markets, the UK is unique in applying Stamp Duty to share transactions. It is informative that the Shanghai Composite Index closed almost 10 per cent higher the day after its government abolished Stamp Duty.

London Stock Exchange view. By abolishing Stamp Duty on shares, the UK Government has a real opportunity to strengthen our economy. In a recent report, KPMG found that Stamp Duty reduces the total value of UK listed companies by over £133 billion and the total amount of UK capital investment by up to £7.5 billion a year. KPMG also modelled the effect of the abolition of Stamp Duty on the economy. The report found that as a result of higher economic growth following enhanced investment in business, abolition of Stamp Duty would be revenue neutral to the Exchequer within the lifetime of a parliament. It would increase the total amount of capital investment by up to £7.5 billion a year, and deliver a jump of 7.7 per cent in the stock market on the day it is announced.

Way forward = abolish Stamp Duty on share transactions. One of the most significant issues the UK Government could address to help the UK's IPO market become even more competitive is to abolish Stamp Duty on share transactions.

³³ Financial Services and Markets Act 2000 (73 (1) (d)).

³⁴ KPMG, *Building a Sustainable Recovery*, June 2010, p.29.



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About this report

This report was prepared by the
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and comparative analysis of London's IPO market
and its competitors.

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and October 2011.

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