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LSE Group expanding its financial market infrastructure footprint

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10. March. 2014

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Executive Summary

The London Stock Exchange Group's earnings have remained buoyant even as other major exchanges' have stagnated. The LSE Group has expanded the scope of its operations by redefining its business model, transforming itself from a conventional equity exchange to a financial market infrastructure provider.

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Traditional securities exchanges overseas have long faced an adverse growth environment in the wake of the repeal of concentration rules and intensification of competition with other trading venues. In November 2013, NYSE Euronext, a leading cash equity exchange, was acquired by Intercontinental Exchange (ICE), a 10-year-old US derivatives exchange.

What does the future hold for traditional securities exchanges? One example that is instructive in terms of how traditional exchanges could evolve going forward is the London Stock Exchange (LSE). Over the past several years, the LSE Group has adroitly navigated a changing competitive and regulatory landscape and greatly raised its profile as a financial market infrastructure provider. It was presumably motivated to do so by concern about its traditional UK equity IPO and trading business's earnings deteriorating due to price competition with upstart trading venues. Following is a discussion of the LSE Group's growth initiatives in terms of expanding its product offerings and providing post-trade services. The LSE Group's story suggests a new approach to downstream business expansion.

Product offerings: expansion into bonds, derivatives and pan-European equities

Exhibit 1 compares major US and European exchanges' net revenues in 2009 and 2012. While NYSE Euronext and Deutsche Börse, both of which are bigger than the LSE Group, saw their net revenues drop between 2009 and 2012, the LSE Group's revenues grew at a rate second only to ICE's.

The LSE Group's business expansion dates back to its October 2007 acquisition of the Borsa Italiana Group. In the mid-2000s, the LSE Group faced a takeover threat from US and continental European exchanges[1], but it turned the tables by acquiring

NOTE

1) For example, the LSE Group received takeover bids from Deutsche Börse in late 2004, Euronext immediately thereafter, Macquarie Bank in late 2005, and NASDAQ in March 2006.

Exhibit 1. Comparison of major European and US exchanges' revenues

	2009	2012	Change
ICE	$995mn	$1,363mn	37.0%
LSE	$1,005mn	$1,348mn	34.1%
Nasdaq OMX	$1,449mn	$1,663mn	14.8%
CME	$2,613mn	$2,915mn	11.6%
NYSE Euronext	$2,478mn	$2,324mn	-6.2%
Deutsche Börse	$2,845mn	$2,495mn	-12.3%

Notes: (1) The above data are net revenues after deduction of commissions to brokers and other transaction costs. European exchanges' net revenues were converted to US dollars using the average of month-end exchange rates. (2) The LSE Group's net revenues are for the fiscal years ended March 2010 and March 2013.
Source: NRI, based on the above companies' annual reports

the Borsa Italiana Group, thereby capturing business opportunities in continental Europe and geographically expanding its revenue sources.

The Borsa Italiana acquisition enabled the LSE Group to strengthen its presence in markets for assets other than cash equities, including bonds and derivatives. The Borsa Italiana Group owns major European bond and derivatives trading platforms, MTS and IDEM. By acquiring these platforms, the LSE Group is able to offer trading opportunities in a broader range of products.

Additionally, in February 2010, the LSE Group acquired a majority stake in Turquoise, a large multilateral trading facility (MTF)[2] established by a consortium of major investment banks. Some of these investment banks sold their Turquoise shareholdings to the LSE Group in the aftermath of the global financial crisis. The Turquoise acquisition was motivated by a competitive threat posed by the emergence of MTFs and dark pools, new trading venues that sprang from the EU's Markets in Financial Instruments Directive[3] (MiFID), the main provisions of which included a best-execution mandate and repeal of the concentration rule. Capitalizing on their lower costs and faster execution speeds as selling points, the new trading venues were gaining prominence by usurping order flow from conventional exchanges.

With MTFs, investors can trade highly liquid German, French and other European equities at one venue. Through the Turquoise acquisition, the LSE Group added blue-chip European equities to its product lineup in addition to regaining prominence as a trading venue.

2) MTFs are a type of alternative execution venue. Other types include US alternative trading systems (ATS), electronic communication networks (ECN), and securities firms' dark pools, which execute trades by matching customers' orders.

3) MiFID took effect in November 2007.

Services: acquisition of post-trade functions

Historically, the LSE Group had limited capacity to provide post-trade services such as clearing, custody and settlement. Meanwhile, the Borsa Italiana Group owned CC&G, a clearing house, and Monte Titoli, a securities depository and settlement services provider. By acquiring the Borsa Italiana Group, the LSE Group gained post-trade functions for financial products traded on Borsa Italiana markets.

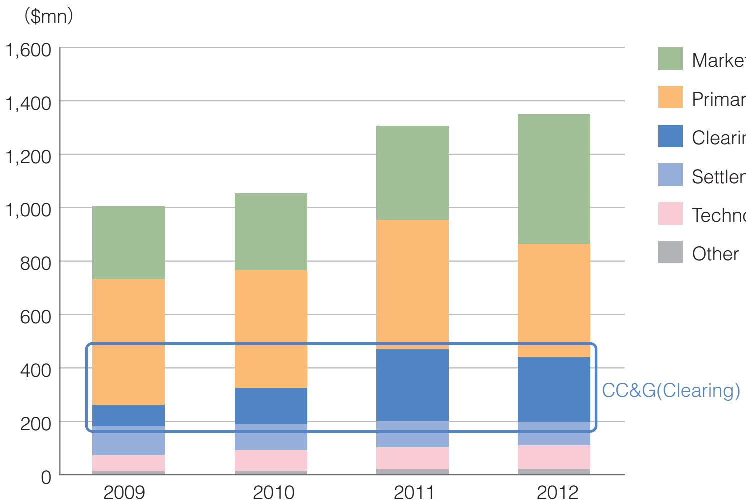
There is less competition in the post-trade services business[4] than in the primary market and trading business, where competition from other trading venues has been intensifying. Additionally, European clearing houses typically earn interest revenues by investing margin deposits. The LSE Group's earnings from clearing services have been steadily growing in recent years (Exhibit 2).

4) Major European clearing houses include EuroCCP and Eurex Clearing in addition to the herein-mentioned LCH.Clearnet.

Business opportunities related to clearing services are expanding, driven largely by the trend toward centralized clearing of derivatives. Following centralization of credit derivative clearing, centralized clearing is now spreading to interest rate derivatives. The interest rate swap clearing volume is growing rapidly. Against such a backdrop, the LSE Group acquired LCH.Clearnet (LCH), a major clearing house, in May 2013[5]. The post-trade knowhow that the LSE Group gained from the Borsa Italiana acquisition was likely very instrumental in the LCH acquisition. LCH operates in not only Europe but the US and Asia also. It offers clearing services for diverse products, including equities, bonds and derivatives. By acquiring LCH, the LSE Group gained business opportunities for a broad range of products in the clearing business also.

5) The LSE Group owns 57.8% of LCH.Clearnet and 60% of Turquoise.

Exhibit 2. Breakdown of LSE Group's revenues



Source: NRI, based on LSE Group's annual report

6) According to Chairman's statement in the LSE Group's fiscal 2011 Annual Report.

7) The LSE Group's other initiatives to strengthen its product offerings include strengthening its market data business also. Specifically, the LSE Group bought out its joint-venture partner, Pearson, owner of the Financial Times, to acquire 100% ownership of index provider FTSE International. Market data are a key revenue source for the LSE Group, as shown in Exhibit 2.

8) Mr. Rolet was a senior executive of Lehman Brothers before assuming his current post in 2009.

The LSE Group's management team formulated an in-depth strategic vision that included business diversification, extrication from overdependence on UK equities, and a goal of providing world-leading financial market infrastructure[6]. The LSE Group has in fact expanded the scope of its operations, as described above[7]. In addition to expanding its range of traded products, it has also expanded its post-trade services, where it was previously unable to gain much of a foothold in its home market, by acquiring LCH based on its experience with the Borsa Italiana Group. Through this process, the LSE Group redefined its business model, transforming itself from a conventional equity exchange into a financial market infrastructure provider. LSE Group CEO Xavier Rolet's background as a financial institution executive[8] presumably played a role in enabling the LSE Group to pursue an innovative growth strategy.

The LSE Group's business expansion strategy was underpinned by strong external growth. Nonetheless, the LSE Group's approach of proactively enhancing its market infrastructure's added-value by offering new products and services instead of confining itself to its traditional business domain is rich with implications for future of the securities exchange business.

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