European Stock Exchanges Seek to Increase Their Asian Business

Takeshi Inoue
Senior Analyst,
Nomura Institute of Capital Markets Research

I. Asian stock markets eclipsing their European rivals

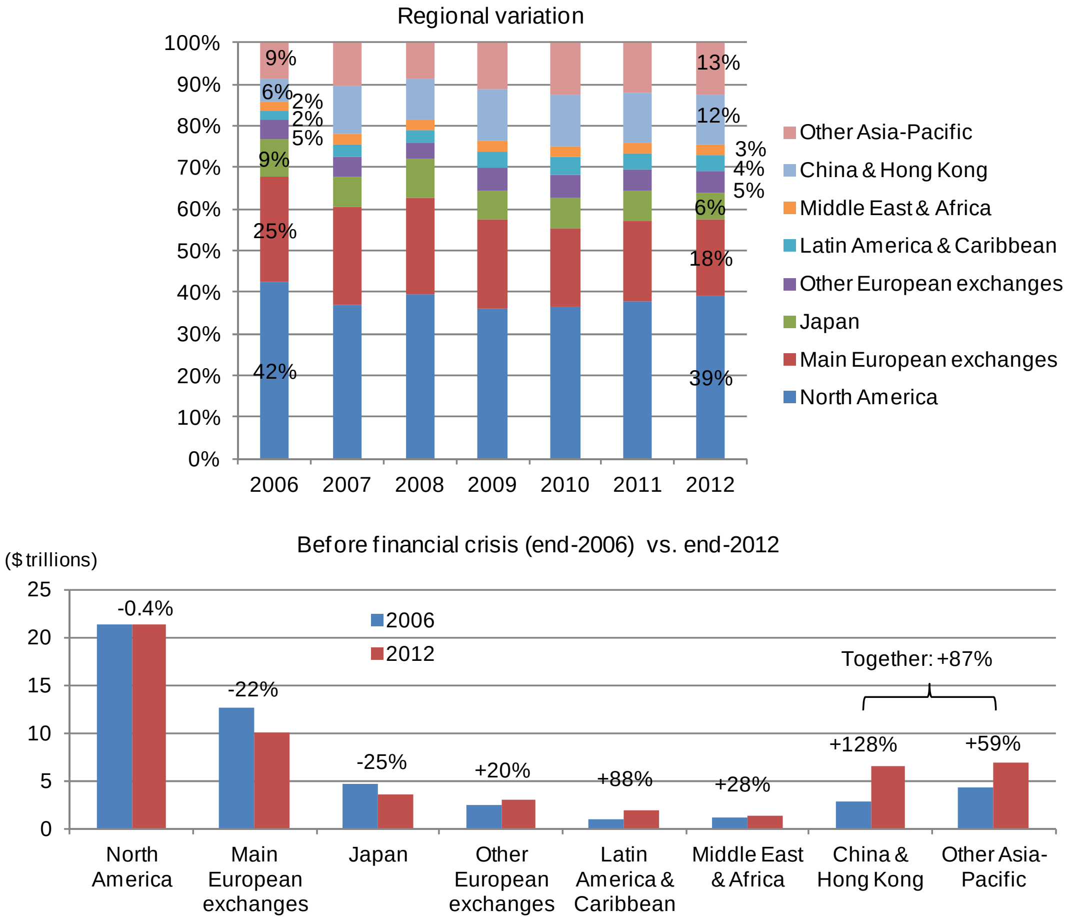
In December 2012 the US derivatives exchange IntercontinentalExchange (ICE) announced it would buy NYSE Euronext, which itself owned several exchanges in the US and Europe. ICE's main aim was seen as acquiring NYSE's exchanges in the US and the NYSE LIFFE derivatives market in London, and there were rumors that it would probably dispose of Euronext. At the same time, there was speculation that Deutsche Börse, which had previously mounted a bid for NYSE Euronext that it had had to withdraw in February 2012 after the European Commission blocked the merger, might mount another bid. However, comments by Deutsche Börse's CEO, Reto Francioni, indicate that Deutsche Börse was not particularly interested in European markets[1]. Meanwhile, in November 2012, the London Stock Exchange (LSE) and Singapore Exchange (SGX) began trading each other's main listed stocks.

We attribute these recent moves by European stock exchanges to increase their Asian business to the slow pace of recovery by European stock markets compared with that in other parts of the world. In Europe the global financial crisis that began in 2008 has been compounded and prolonged by other crises, including fiscal crises in a number of countries, the euro crisis, and the slow pace of economic recovery as a result of deleveraging by the banks and government austerity programs.

From the end of 2006 to the end of 2012 global stock market capitalization increased by 8%. However, a closer look reveals that, while it declined on each of the three leading markets (North America, Europe, and Japan), it increased elsewhere—an indication that the demise of the G7 (or the rise of the G20) has also been proceeding apace on stock markets. During this period, the market capitalization of the main European markets declined by 22%, while that of Asia-Pacific markets (ex Japan, similarly below) rose by 87% (Figure 1). As a result, the market capitalization of Asia-Pacific markets as a percentage of global stock market capitalization surpassed that of the main European markets at the end of 2009 and, at 25%, is now second only to that of North America. In contrast, that of the main European markets has gradually declined and now stands at 18%[2].

1 "Deutsche Börse eyes LatAm and Asia growth," Financial Times, January 21, 2013.

Figure 1: Market capitalization by region



Note: See Footnote 1.
Source: Nomura Institute of Capital Markets Research, based on World Federation of Exchanges' data

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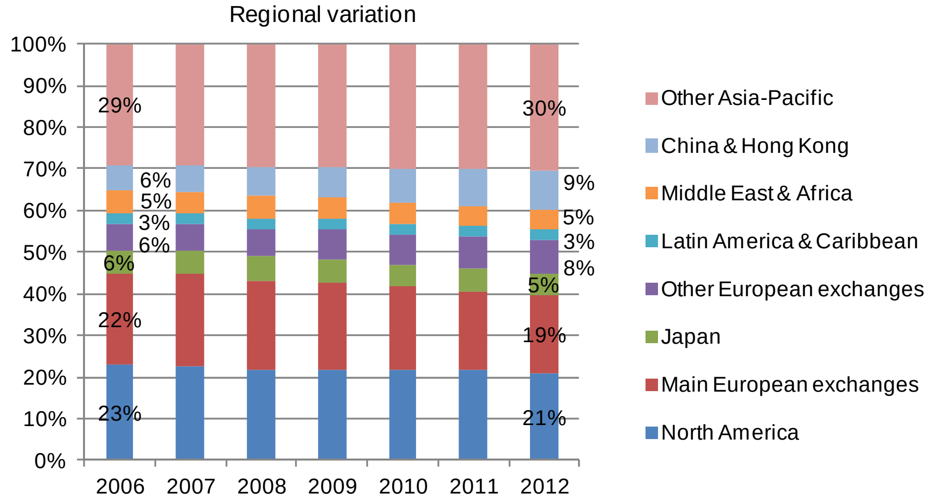
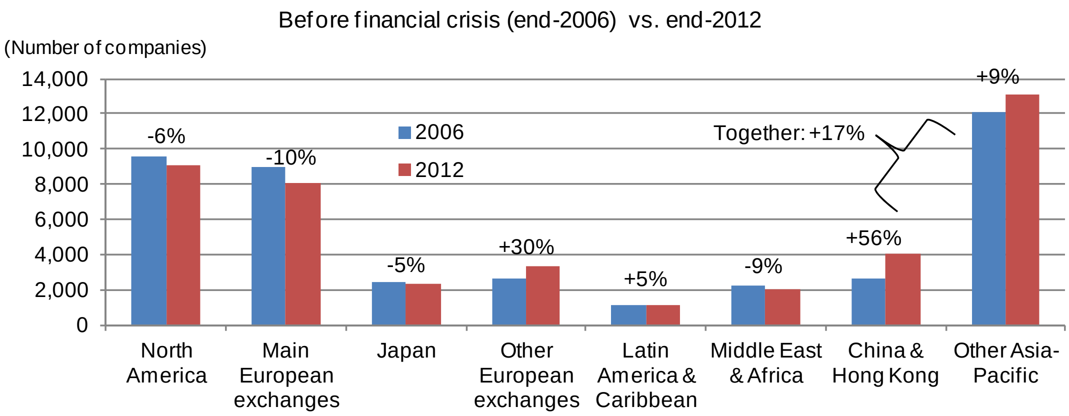
[2] The figures used in this report and its exhibits have been calculated by Nomura Institute of Capital Markets Research using data published by the World Federation of Exchanges. Readers should note that not all of the world's exchanges are covered. Exchanges have been grouped regionally as follows. "North America": NYSE Euronext (US), NASDAQ OMX (US), TMX Group, Bolsa Mexicana de Valores. "Main European exchanges": London Stock Exchange, Deutsche Börse, NYSE Euronext (Europe), Borsa Italiana, BME Spanish Exchanges, SIX Swiss Exchange. "Japan": Tokyo Stock Exchange, Osaka Securities Exchange (trading value only). "Other European exchanges": NASDAQ OMX (Nordic countries), Oslo Børs , Irish Stock Exchange, Wiener Börse, Bourse de Luxembourg, Athens Exchange, Malta Stock Exchange, Cyprus Stock Exchange, MICEX-RTS Stock Exchange (since 2009 only), Warsaw Stock Exchange, Budapest Stock Exchange, Borsa Istanbul, Ljubljana Stock Exchange. "Latin America and Caribbean": Bermuda Stock Exchange, BM&FBOVESPA, Bolsa de Comercio de Buenos Aires, Bolsa de Valores de Colombia, Bolsa de Valores de Lima, Bolsa de Comercio de Santiago. "Middle East & Africa": Tel-Aviv Stock Exchange, Abu Dhabi Securities Exchange (since 2011 only), Amman Stock Exchange (since 2008 only), Muscat Securities Market (since 2010 only), The Egyptian Exchange, Tehran Stock Exchange, Casablanca Stock Exchange (since 2011 only), Johannesburg Stock Exchange, Stock Exchange of Mauritius. "China & Hong Kong": Shanghai Stock Exchange, Shenzhen Stock Exchange, Hong Kong Exchanges and Clearing. "Rest of Asia-Pacific (ex Japan)": Australian Securities Exchange, Korea Exchange, Singapore Exchange, Taiwan Stock Exchange, BSE, National Stock Exchange of India (trading value only), Bursa Malaysia, Colombo Stock Exchange, Indonesia Stock Exchange, Philippine Stock Exchange, Stock Exchange of Thailand.

The number of listed companies tells a similar story. Whereas the number has declined in North America, on the main European markets and in Japan, elsewhere (apart from the Middle East and Africa) it has increased. While a simple comparison of the number of listed companies may not be appropriate in that it does not take account of factors such as (1) the impact of the decline in the number of companies in the developed economies as a result of M&A activity and (2) the large number of SMEs listed on emerging market stock markets that do not form part of institutional investors' universe, it is probably fair to say that, since enterprise value tends to increase as an economy develops, the number of listed companies indicates a market's potential (Figure 2).

Figure 2: Number of listed companies by region





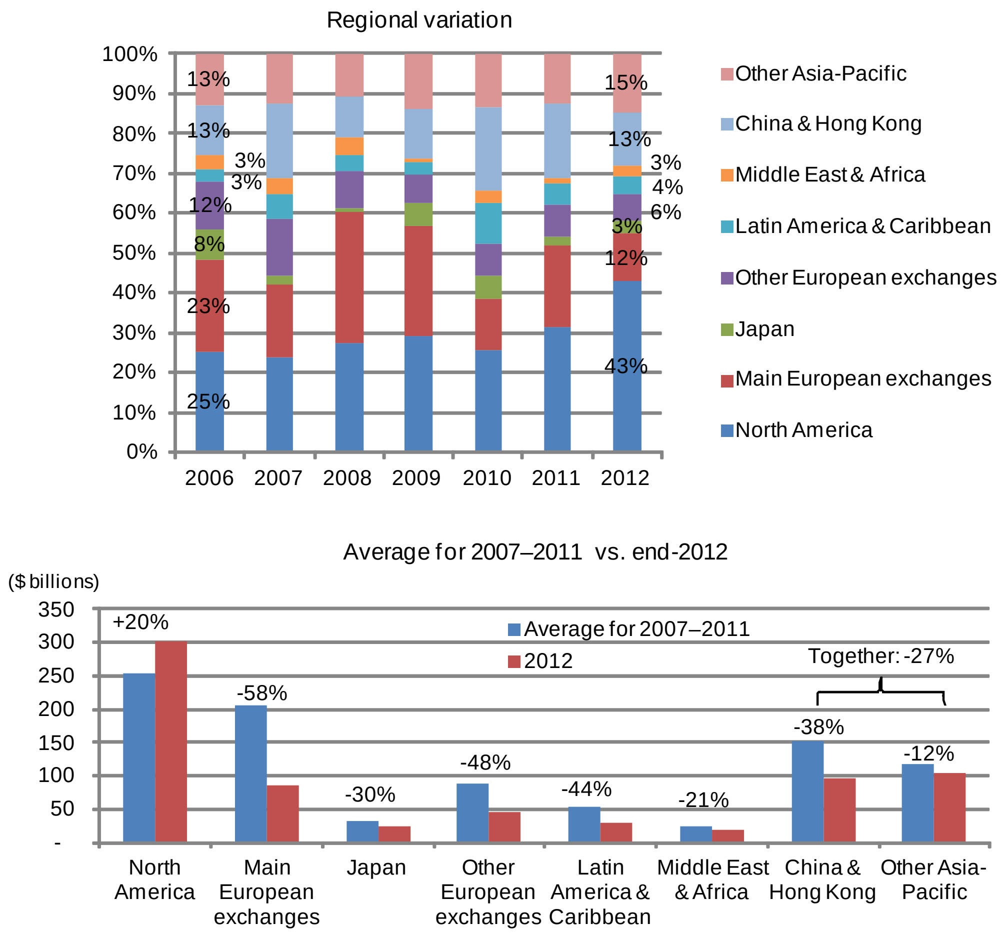
Note: See Footnote 1.
Source: Nomura Institute of Capital Markets Research, based on World Federation of Exchanges' data

II. Asian stock markets also active markets

What picture does market activity paint, however? As far as the primary market is concerned, Figure 3 gives a breakdown of IPOs and capital increases (including third-party allotments) by region. Apart from the US, where a wide range of indicators show signs of an economic recovery, primary market activity in all the other regions was subdued in 2012. 2012 saw a particularly marked decline in primary market activity in Europe, which was hit by the global financial crisis and sovereign debt crises in a number of European countries. As a result, new equity issuance in the main European countries was only 40% of the average for 2007–2011.

New equity issuance was also 38% lower in China and Hong Kong, both of which suffered from weak stock markets, while IPOs remain suspended on the mainland. Elsewhere in the Asia-Pacific region, however, the decline in primary market activity was a relatively moderate 12%. Similarly, apart from 2008 and 2009, when financial institutions around the world were busy raising capital in response to the financial crisis, a comparison of new equity issuance in Asia as a whole and the main European

Figure 3: Initial public offerings and capital increases (incl. third-party allotments) by region



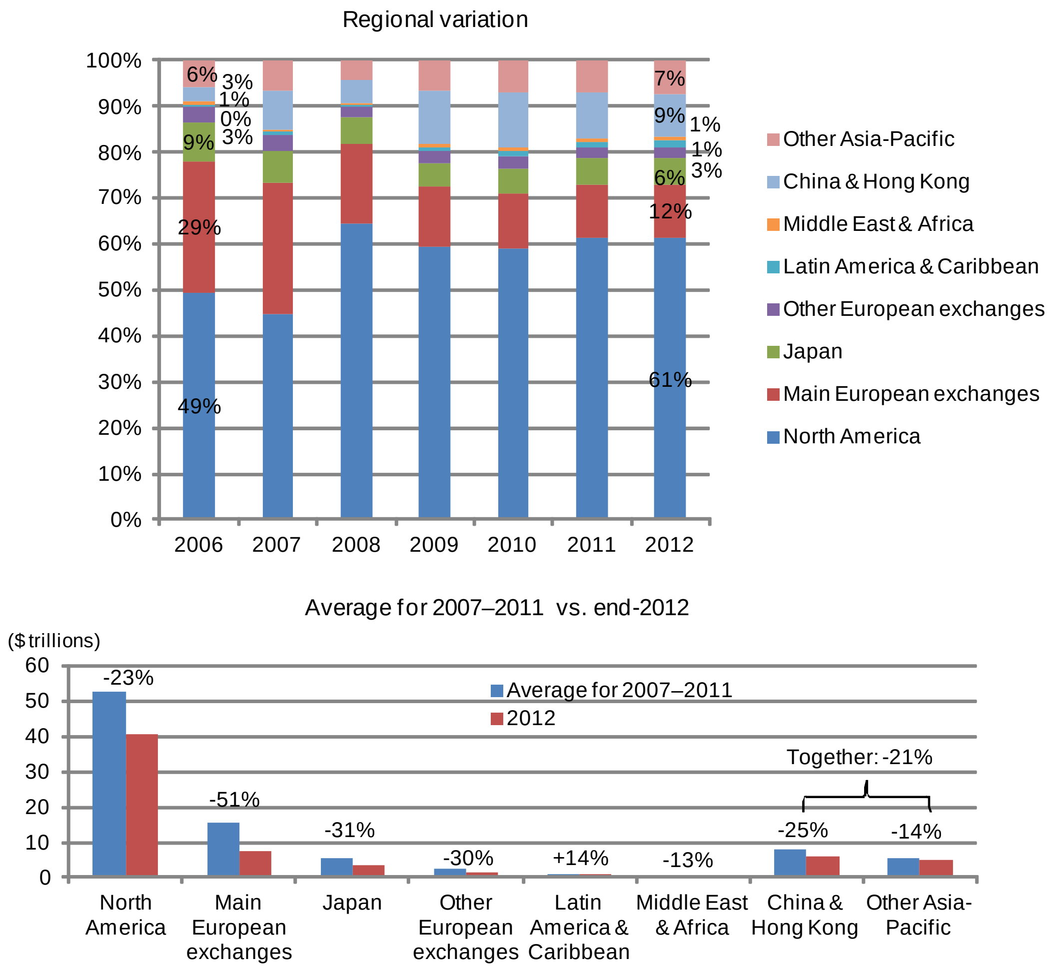
Note: Regions as in the other exhibits. See Footnote 1.
Source: Nomura Institute of Capital Markets Research, based on Bloomberg data

markets shows that the former has surpassed the latter and that Asian markets are now comparable in size to the main European markets when it comes to primary market activity.

A comparison of trading value tells a similar story: whereas trading value on the main European markets was 51% lower in 2012 than the average for 2007–2011, it was only 21% lower for the whole of Asia. As with primary market activity, the decline in trading value on Asia-Pacific markets other than China and Hong Kong (14%) was relatively moderate (Figure 4).

The slump in trading value on European stock exchanges is the result not only of economic factors but also of regulatory changes. In 2007 the European Union's *Markets in Financial Instruments Directive* (MiFID) came into effect, leading to the abolition of the "concentration rule" in those European countries that still required all trades to be executed on regulated markets and opening these markets to competition. Those multilateral trading facilities (MTFs) that now compete for this business with

Figure 4: Trading value by region



Note: See Footnote 1.
Source: Nomura Institute of Capital Markets Research, based on World Federation of Exchanges' data

their sophisticated computer systems and aggressive fee pricing have captured a large share of the market from the stock exchanges. As of end-March 2013, Deutsche Börse accounted for 65% of the value of trading in DAX stocks, while the LSE accounted for 59% of the value of trading in FTSE 100 stocks, and Euronext 63% of the value of trading in CAC 40 stocks.

It is perhaps worth mentioning in this context that the greatest decline in the share of stock exchange trading has occurred in the US, where the New York Stock Exchange now accounts for only 26% of trading in the Dow Jones Industrial Average (DJIA), and the NYSE Group as a whole only 38%[3]. Similarly, the NASDAQ accounts for only 45% of trading in the NASDAQ 100, the NASDAQ OMX Group's leading stock index[4]. Nonetheless, trading value on US stock exchanges is still much higher than that on European exchanges. Be it because of weak economic growth in Europe or because of the loss of business to alternative trading systems, the fact is that trading volume on European stock exchanges has slumped.

III. European stock exchanges looking to Asia

Although the Japanese stock market has recently staged a recovery, the global picture until 2012 was that of a stock market recovery in the US, a solid stock market performance in Asia ex Japan, and a weak stock market in the main European countries. Although the US stock market is large and trading is active, US stock exchanges were obliged to face the pressure of competition sooner than those in Europe. It is therefore natural that European stock exchanges should look, first of all, to Asia with its large yet relatively young and active stock markets to help them out of their slump.

In terms of both its stock markets and the size of its economies, Asia is already on a par with the industrialized countries and has passed the stage where it grew rapidly as it caught up with them (Figure 5). If they were to continue to grow rapidly, they might actually face the risk of a bubble. However, so long as economic growth in the region remains high by international standards, the region's stock markets can also be expected to continue to show solid growth. Undoubtedly, they must be more attractive than their European counterparts, which remain mired in a slump.

As well as looking for opportunities in Asia, European stock exchanges are looking to build on their experience with derivatives. As the international rules governing trading in derivatives are tightened, the use of organized platforms and central clearing is due to be made compulsory for standard OTC derivatives. As the OTC market is 10 times larger than exchange markets, the exchanges are expecting a huge opportunity.

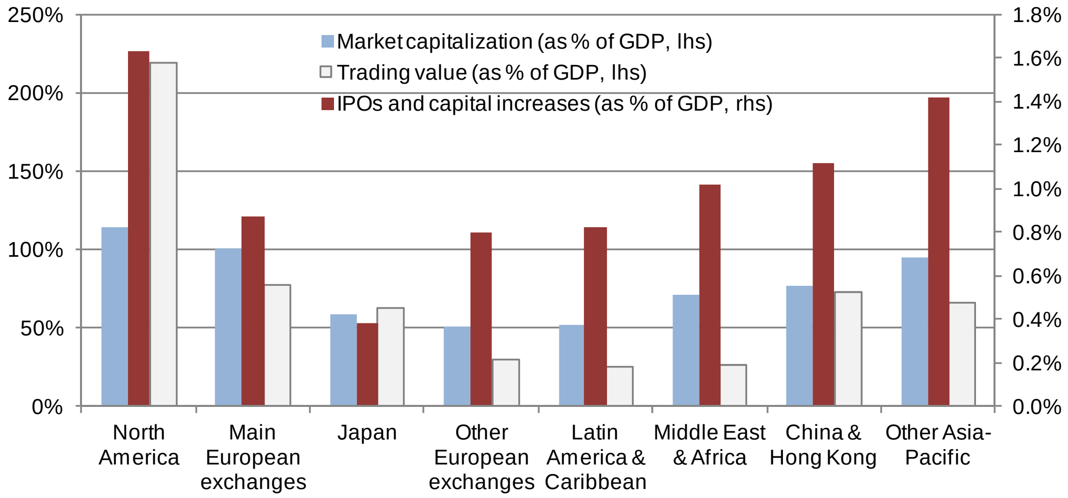
Last year, however, exchange trading in derivatives, which held up better than exchange trading in equities in the wake of the financial crisis, declined by 15%

[3] The NASDAQ accounts for 23% of trading.
[4] The NYSE Euronext Group accounts for 15% of trading.

worldwide and appears to be approaching a turning point (Figure 6). This was the first time since 2004 that trading volume declined year on year on an annual basis. We attribute this to lower market volatility as a result of the anemic economic recovery that has followed the financial crisis and to the end of the decline in interest rates. Although the OTC derivatives market is huge and largely untapped, it may not be as profitable as some imagine.

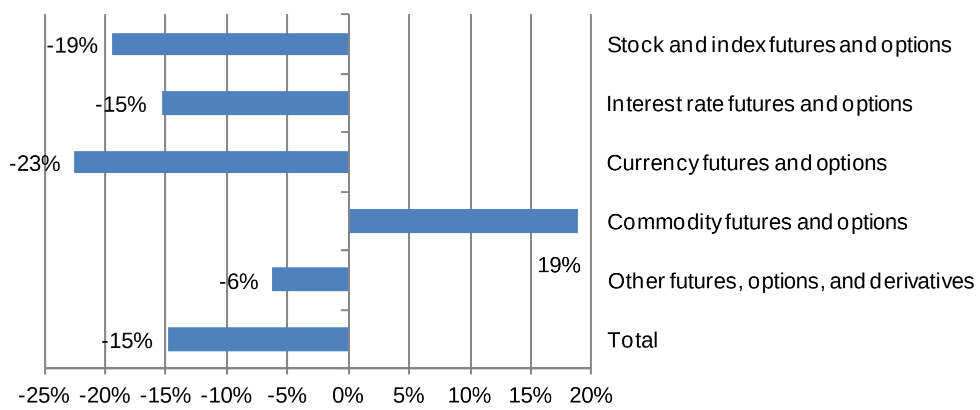
It would probably be fair to say that the strategy of most European stock exchanges for the time being is to seek to tap the potential of part of the OTC derivatives market and to benefit from the growth of Asian markets.

Figure 5: Stock markets and size of economy



Note: Data for 2012. Regions as in the other exhibits. See Footnote 1.
Source: Nomura Institute of Capital Markets Research, based on World Federation of Exchanges, Bloomberg, and IMF data

Figure 6: Change in derivative trading (2012/2011)



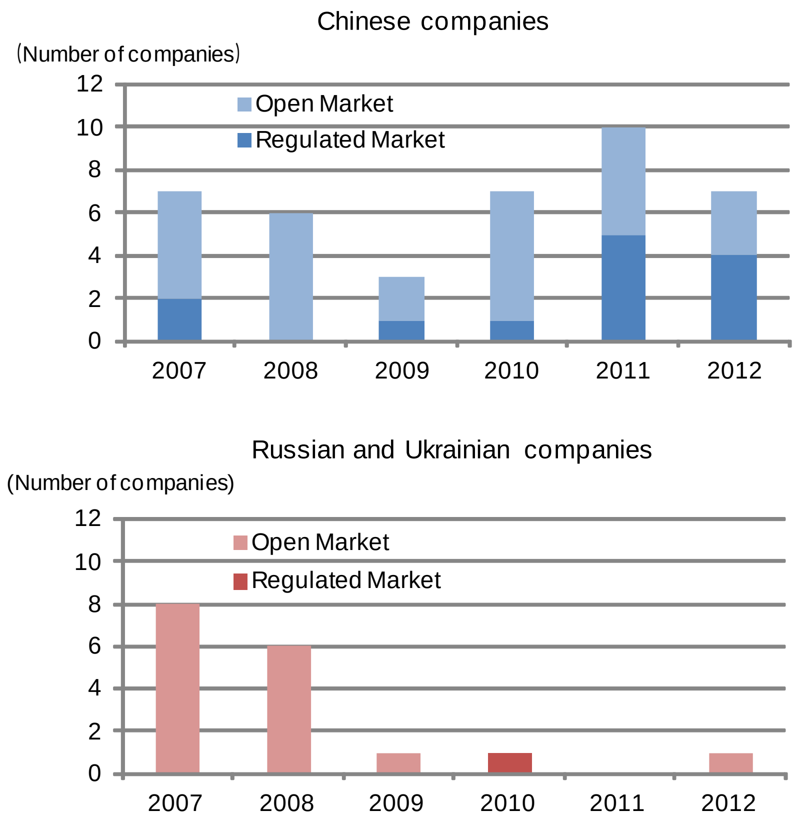
Source: Nomura Institute of Capital Markets Research, based on World Federation of Exchanges' data

IV. Winning over Asian issuers and investors

As its growth strategy for 2013 Deutsche Börse has set itself three goals: (1) to extend its products and services to hitherto unregulated/uncollateralized markets (e.g., the OTC market), (2) to expand technological leadership, and (3) to increase its reach in new customer groups and growth regions, especially Asia and South America[5]. It has put considerable effort across all its transaction cycles (including the cash market, derivatives, clearing/settlement, and its index business) into expanding its Asian business.

Its cash market segment has put considerable effort into listing Chinese companies. Since 2007, a total of 40 Chinese companies[6] have listed on the exchange's Regulated Market and its Open Market[7], with seven new listings taking place in 2012. In the early days, the exchange also made an effort to encourage Russian and Ukrainian companies to list, but the number of such listings has dwindled (Figure 7). Until 2010

Figure 7: Emerging economy company listings on Deutsche Börse



Source: Nomura Institute of Capital Markets Research, based on Deutsche Börse data

5 See Deutsche Börse Group, *Corporate Report 2012*, Page 13 for further details.

6 Whereas the Regulated Market is governed by EU law, the Open Market is not a Regulated Market but operated by the Regulated Market.

7 In order to increase investor protection, the rules governing the Open Market were substantially revised in 2012, with those governing matters such as disclosure, capital requirements, and the number of floating shares being tightened. Since then, companies that were already listed on the exchange have been relisting. Thus far, 13 Chinese companies have relisted: five on the Regulated Market and eight on the Open Market.

the exchange also included Central and Eastern Europe among its main emerging market targets. However, as a result of the impact the global financial crisis and the European debt crisis have had on the region, it decided in 2013 to remove them from its target list.

Since 2011, Deutsche Börse has sought to increase the international coverage of the STOXX indices, which it jointly owns with SIX Swiss Exchange. Here, too, it has shown its commitment to making the most of Asian markets. In September 2012, for example, it rolled out indices for Chinese A shares, B shares, H shares, and red chips. It has also been extending its index coverage to other markets in the Asia-Pacific region. As a result, as of end-2012, the region accounted for 51% (i.e., roughly half) of the total number of STOXX indices[8].

Since August 2010, Deutsche Börse's derivatives segment (Eurex) has operated a cooperation agreement with the Korea Exchange (KRX) whereby members of each are able to deal in KOSPI derivatives. Open positions in the Eurex KOSPI product are transferred to KRX at the close of trading every day, giving KRX what is effectively an after-hours trading session on Eurex and market participants the opportunity to trade the KOSPI round the clock. Eurex plans to operate a similar arrangement with the Taiwanese futures exchange TAIFEX from the fourth quarter of 2013.

In July 2012 the LSE signed an agreement with SGX under which each exchange can trade the other's main stocks. Since November 2012, market participants have been able to trade 39 leading Singapore stocks on the LSE's newly established International Board. Trading in FTSE 100 stocks is due to start on SGX in the first half of 2013.

International Board trades will be cleared by LCH.Clearnet and settled by Central Depository Pte., an SGX subsidiary. Like other exchanges, the LSE is keen to expand the clearing and settlement business of its cash and derivative trades. It therefore plans to acquire LCH.Clearnet in the second quarter of 2013[9]. The tie-up with SGX has also boosted LCH.Clearnet's international business.

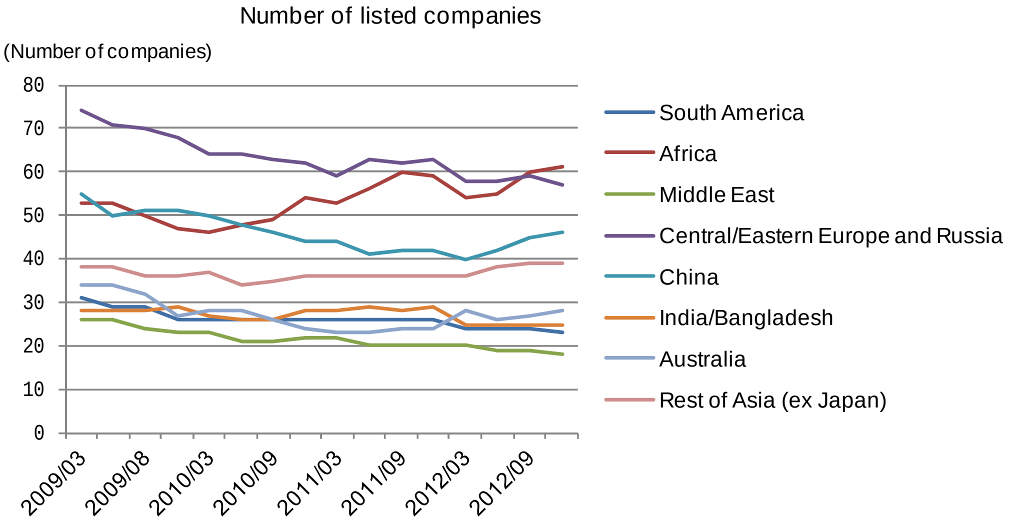
As an international stock exchange the LSE has a long history of seeking to attract listings by foreign companies. In the case of emerging economy companies, it lists large-capital stocks, often in the form of depositary receipts, on its main market and has been actively listing small-capital stocks, growth stocks, and start-ups on AIM.

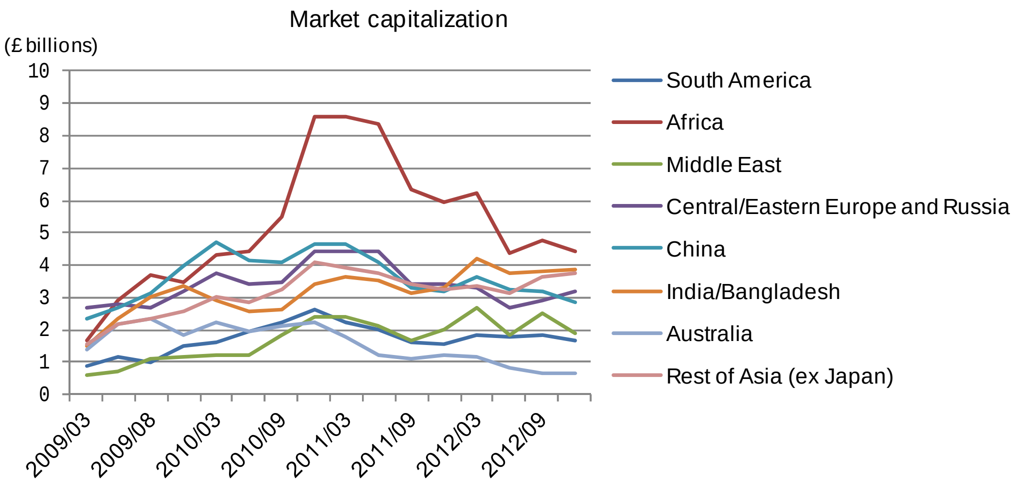
In recent years AIM has also been affected by the global financial crisis, with trading volume declining to roughly half, and market capitalization to roughly 60%, of its 2007 peak level in 2012. Despite this, however, the market capitalization and number of listings of Asian (ex Chinese and Indian) companies have been increasing in both absolute and relative terms, and in contrast, for example, to those of Central and East European companies, which have declined markedly (Figure 8)).

8 See Deutsche Börse Group, *Corporate Report 2012*, Page 46 for further details.

9 On 27 March 2013 LCH.Clearnet's shareholders approved an increase in the LSE's shareholding from 2.3% to 57.8%.

Figure 8: Emerging economy company listings on AIM





Source: Nomura Institute of Capital Markets Research, based on London Stock Exchange data

In addition, in 2009 the LSE acquired the Sri Lankan IT company Millennium Information Technologies and has replaced most of its own computer system with a MillenniumIT system. Furthermore, MillenniumIT has supplied the computer systems used by exchanges such as the Mongolian Stock Exchange and Bursa Malaysia, and is keen to do more business in Asia. As a result, Asia's share of the London Stock Exchange Group's business has increased rapidly.

Another noteworthy example of a European exchange attracting Asian money was the acquisition of the London Metal Exchange (LME) by Hong Kong Exchanges and Clearing (HKEx) in December 2012. The two exchanges saw the deal as a way of making more money out of the growing demand from Asia (including China, the world's biggest consumer of metals) for metal futures. HKEx's chief executive, Charles Li, has said that LME will introduce an "Asian session" and permit settlement in renminbi[10].

[10] From HKEx's 15 January 2013 press release "HKEx Chief Executive Charles Li's Elaboration on HKEx's Strategic Plan 2013-2015."

V. More challenges ahead for Europe; possibility of mergers with Asian counterparts

The amendments to MiFID now under discussion in Europe are likely to result in tighter regulation of algorithmic and high-frequency trading, which are said to account for about 40% of equity trading. Much will depend on the details. However, there is concern that the new regulations could affect not just the kind of trading that threatens to destabilize the market but also market making, an important source of liquidity. Also under discussion is a proposal to introduce a financial transaction tax in 11 European Union member states. Some EU states, such as France and Italy, have already introduced such a tax[11]. All of these measures threaten to have a significant impact on European securities markets.

As we have seen, European stock markets remain mired in uncertainty as a result of both their struggle to recover from financial and economic crisis, and tighter regulations. We can therefore expect them to continue for some time to look to Asia. In Asia itself developments such as the rapid growth of China's stock exchanges have led to fierce competition among stock exchanges for the role of financial center. This probably explains, at least in part, the willingness of exchanges such as KRX and SGX to cooperate with European exchanges. There have also been attempts at mergers between Asian exchanges, including SGX's failed attempt to acquire[12] the Australian Securities Exchange.

As the comment by Deutsche Börse CEO Reto Francioni that the exchange was focusing "on organic growth in Asia and then on joint ventures" indicates[13], many of the attempts by European stock exchanges to increase their Asian business have been extrapolations of their existing business. If, however, European stock exchanges are to participate more directly in Asia's growth and on a larger scale, there may well be more radical moves such as mergers. Last year's merger between HKEx and LME may well have been a harbinger of things to come.

Just as the late 2000s saw "transatlantic" mergers between North American and European exchanges, such as that between the NYSE and Euronext and the NASDAQ's acquisition of OMX, the prospect of "transcontinental" mergers between European and Asian exchanges, and of "transpacific" mergers between North American and Asian exchanges, may not be such a distant one.

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11 See Kodachi, Kei and Inoue, Takeshi, "Oushuu no Kin'yuu Torihikizei no Dounyuu ni Muketa Tenkai" (Background to Introduction of EU Financial Transaction Tax), Capital Market Quarterly, Spring 2013 (in Japanese).

12 In October 2010 the Australian Securities Exchange and Singapore Exchange began discussions on a merger. However, in August 2011 the move was blocked by the Australian Department of Finance and Deregulation and fell through.

13 "Deutsche Boerse CEO Says Asian Expansion as Top Priority" Bloomberg, February 20, 2013.