London Stock Exchange

LSE

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LSE Snapshot +

Fat Prophets take some profits

Shares of London Stock Exchange Group (LON.LSE) have taken off in 2019, climbing nearly 80% since the end of 2018 as at the close of Wednesday trading. The shares had steadily risen in the first half of 2019 on the back of solid fundamental performance, an improvement in risk sentiment after the broader market sell-off in late 2018, and as expectations for more stimulus from central banks around the world set in. M&A activity has turbocharged the appreciation of the shares over the past couple of months. We review the state of play.

The background – HKEX enters the fray

In a surprise move last week, Hong Kong Exchanges and Clearing Limited (HKEX) which is the bourse operator in Hong Kong approached London Stock Exchange Group (LSEG), with an early proposal that they combine the two companies.

The proposed transaction implied a value of circa 8,361p per share for LSEG, equating to approximately £29.6 billion for the equity of the company, and implying an enterprise value of £31.6 billion (including net debt and other adjustments).

That represented a premium of 22.9% to the closing share price of 6,804p per LSEG share on 10 September 2019; and a premium of 47.4% to the closing price of 5,672 pence per LSEG share on 26 July 2019, the last trading date before the first announcement of the Refinitiv transaction. The price tag was hefty, at a multiple of 30.2x times 2018 reported earnings before interest, tax, depreciation, amortisation and impairments. **A key facet of the proposed deal that we believe ultimately doomed it in its first incarnation, was that the cash**

component of the transaction was relatively low. LSEG shareholders would have receive 2,045 pence in cash and 2.495 newly issued HKEX shares per LSEG share.

A combination of the two major bourses would create a global player that links East and West capital flows. It would be the third largest stock exchange group in terms of the value of the companies listed on those bourses, behind the New York Stock Exchange and Nasdaq.

Charles Li, Chief Executive of HKEX, said: "*Bringing HKEX and LSEG together will redefine global capital markets for decades to come. Both businesses have great brands, financial strength and proven growth track records. Together, we will connect East and West, be more diversified and we will be able to offer customers greater innovation, risk management and trading opportunities. A combined group will be strongly placed to benefit from the dynamic and evolving macroeconomic landscape, whilst enhancing the long-term resilience and relevance of London and Hong Kong as global financial centres.*"

It was a major surprise though as LSEG already has a major bid in play to takeover data firm Refinitiv. **Many, including ourselves regard the Refinitiv takeover as a good strategic direction for LSEG**. HKEX's offer was conditional on LSEG terminating its proposed acquisition of Refinitiv.

LSEG's early response was that the offer was "*highly conditional*" and "*preliminary.*" A released statement from LSEG said, "*The Board of LSEG will consider this Proposal and will make a further announcement in due course.*" The statement added, "*LSEG remains committed to and continues to make good progress on its proposed acquisition of Refinitiv Holdings Ltd as announced on 1 August 2019. A circular is expected to be posted to LSEG shareholders in November 2019 to seek their approval of the transaction.*"

LSEG shares closed 5.9% higher on the news though last week, after falling from a much higher spike on that first day as the implications of the offer were mulled. In Hong Kong, there is the ongoing protests, while in the UK, Brexit and political uncertainty.

LSEG's Board has since unanimously rejected the transaction, which is no great surprise and we concur with the decision.

Among the factors LSEG cited for rejecting the offer from the Hong Kong bourse operator was that the proposed acquisition of Refinitiv is a transformational transaction, strategically and financially. The proposed acquisition saw LSEG shares stage strong gains from when it was made public in late July. LSEG said its "*Board is confident that significantly greater value can be achieved.*"

LSEG also said the valuation offered fell "*substantially short*" for what it considers an appropriate takeover value, especially given the further value the Board believes can be added via the Refinitiv transaction. As we noted earlier, LSEG also highlighted the high share consideration component as unattractive, as this can fluctuate considerably. Finally, the rejection cited "Serious Deliverability Risk" referring to the required approval from a raft of regulators and government entities. HKEX's Board structure and relationship with the Hong Kong government would also be a thorn in the side on that front.

HKEX was undeterred with the rejection from LSEG last Friday and said it intends to reach out to LSEG shareholders. The statement in response from HKEX said, "*The Board of HKEX continues to believe that the proposed combination with LSEG represents a highly compelling strategic opportunity to create a global market infrastructure leader.*"

It went on to say the company had "*hoped to enter into a constructive dialogue with the Board of LSEG to discuss in detail the merits of its proposal and are disappointed that LSEG has declined to properly engage.*"

HKEX proceeded to say it believed that shareholders in LSEG should have the opportunity to analyse in detail both transactions and "*will continue to engage with them.*"

<u>We doubt this bid will be successful, as many are already very optimistic about LSEG's proposed transaction to acquire Refinitiv and will be wary of the factors the LSEG Board cited in its rebuff of the HKEX proposal.</u> HKEX could increase its cash component to try and push its case, but would be stretched to increase it substantially in our view. The other factors are valid hurdles and not easily overcome. **We therefore believe that a combination of HKEX and LSEG is unlikely to be the outcome.**

We view LSEG's proposed acquisition of Refinitiv favourably, for reasons we shall summarise below. However, given the additional lift in LSEG's stock price following the HKEX proposal, rapid appreciation of the LSEG shares in 2019 and elevated valuation on this optimism, we recommend Members take some profits off the table to lock them in at this juncture.

Accordingly, we recommend Members sell-half of London Stock Exchange Group around the current price.

To a data-driven future

We are though content to retain a position in LSEG given the strong long-term prospects from the Refinitiv transaction, which we expect to eventually proceed. It will face a few approval hurdles of its own, but we believe it has a significantly higher probability of proceeding than the LSEG and HKEX combination.

To recap, LSEG shares surged 15% in late July, after the company confirmed it was in advanced discussions to buy financial data analytics firm Refinitiv Holdings for an enterprise value of approximately $27 billion (that price tag includes Refinitiv debt) in an all share deal. The company believes the potential transaction would offer significant customer benefits across a range of its businesses and we concur, as do many investors.

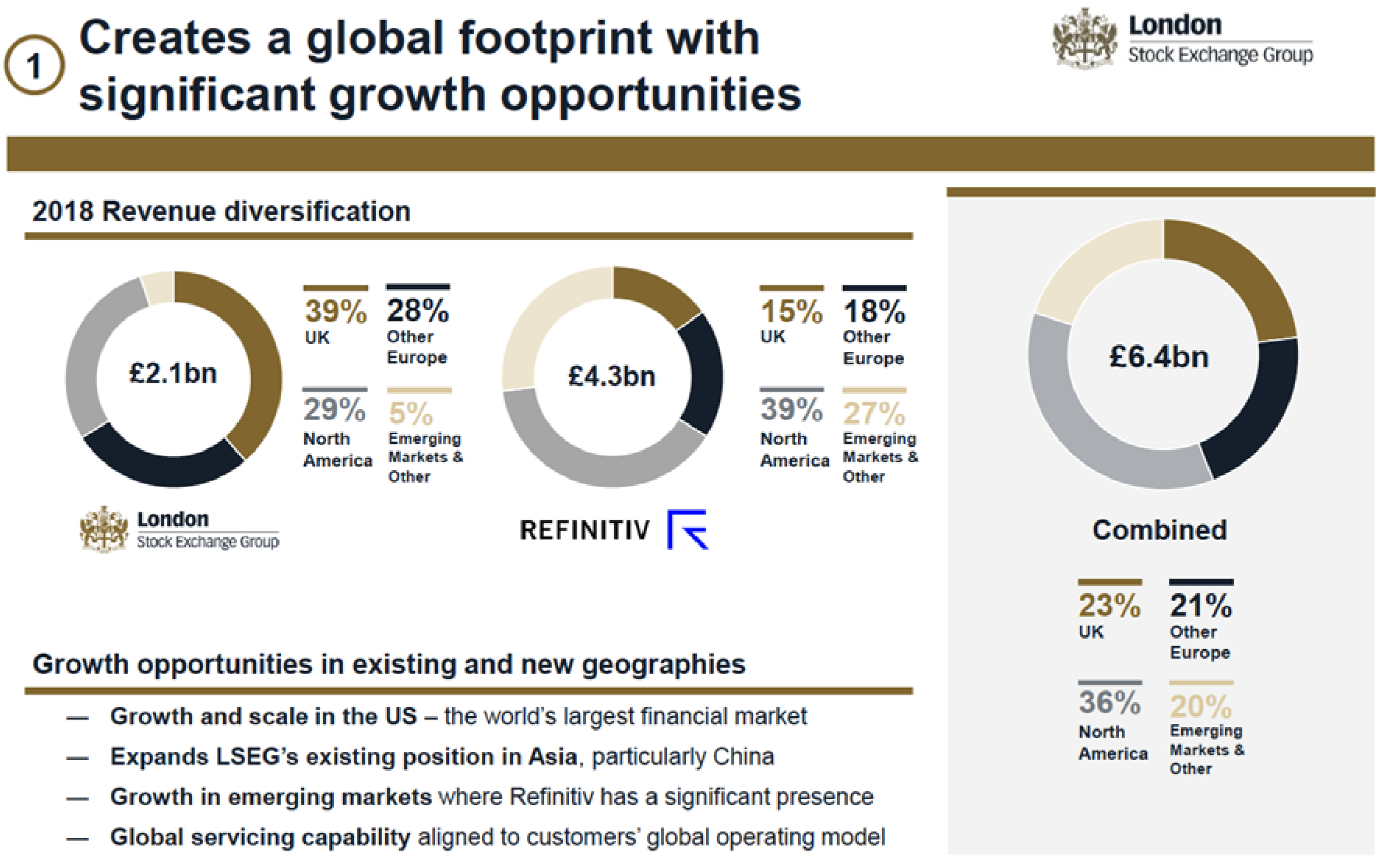
That offer was soon confirmed and bedded down, and it highlights a major tilt towards data for LSE's future. The company had already reportedly spent more than £4 billion on acquiring data and clearing businesses under former CEO Xavier Rolet, but this deal is on an entirely new level. Information services tend to provide more stable cash flows than typical transaction driven businesses.

The Refinitiv deal is an ambitious gambit for LSE and would be its largest acquisition by a country mile. It comes after regulators squashed its deal to merge with Deutsche Börse over 18 months ago, and as the possibility of a chaotic Brexit looms that would likely impact the city of London's high-profile role in global finance.

The proposed transaction came less than a year after a consortium led by Blackstone acquired a 55% stake in Refinitiv from Thompson Reuters, leaving Thompson Reuters with the remaining 45%. That deal was undertaken for an enterprise value of $20 billion, so the $27 billion price tag marks a significant step-up in the valuation. **Nonetheless, the surge in LSE shares over the past year gives it valuable scrip to undertake the transaction.**

The all-share transaction will see Refinitiv Shareholders ultimately holding an approximate 37% economic interest in LSEG and less than 30% of the total voting rights of LSEG. The purchase price represents a reasonable 2018 EV/Adjusted EBITDA multiple of 11.9x.

Recurring revenue would increase from about 40% for LSEG as a standalone business to 70% for the combined business based on 2018 annual revenue. There is other geographic and revenue diversification benefits and growth opportunities from the transaction.

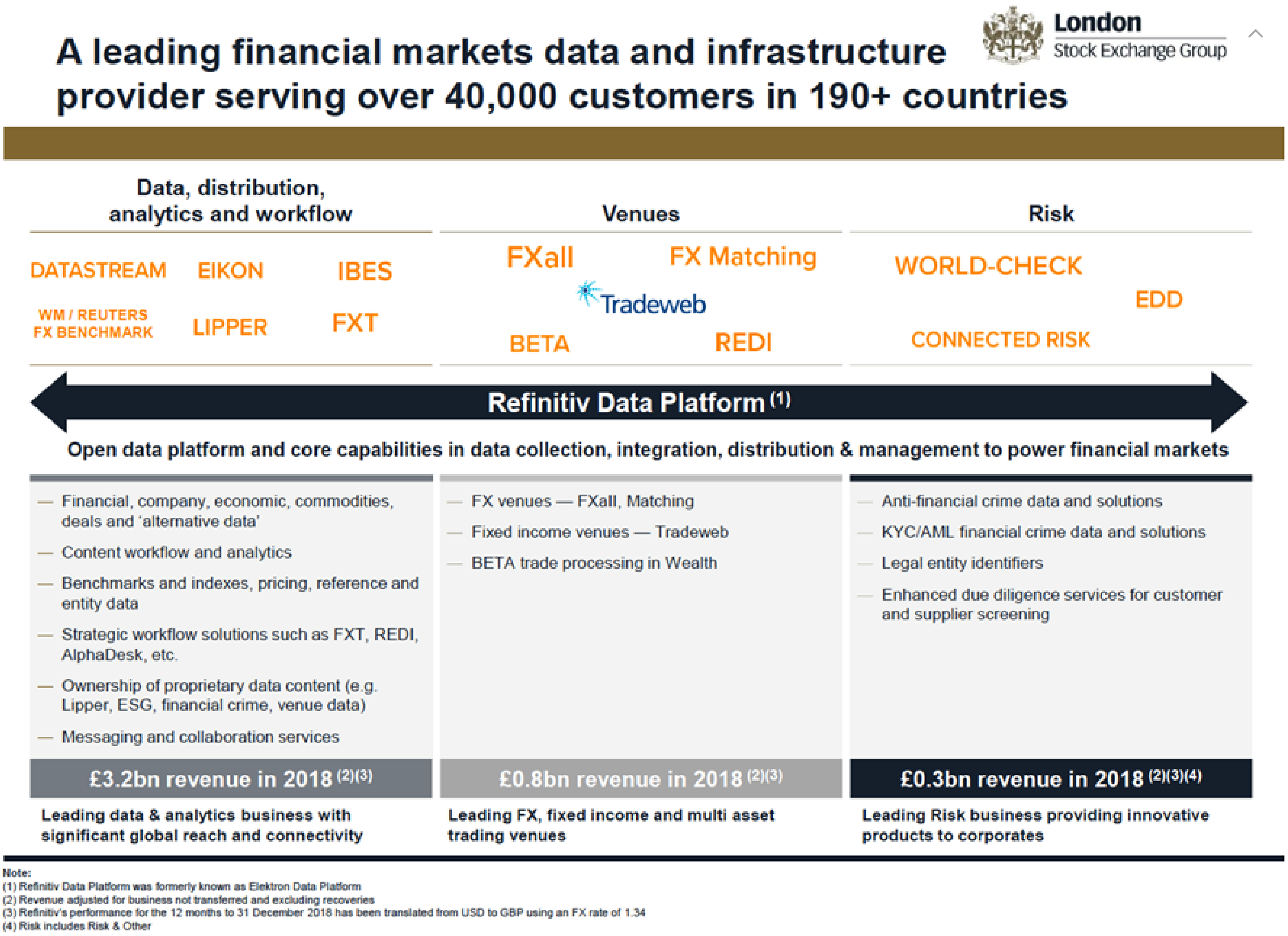


Source: LSEG presentation

Together, LSE and Refinitiv would reportedly be the largest listed global financial markets infrastructure provider by revenue, with combined annual revenues of over £6 billion in 2018. LSE believes annual run-rate cost synergies greater than £350 million would be achievable five years after completion and "*expected adjusted earnings per share accretion of over 30 per cent in the first full year following Completion, increasing in years two and three.*"

Source: LSEG presentation

Refinitiv serves over 40,000 customer institutions across 190 countries with its customer base comprising of a range of buy and sell-side firms, market infrastructure companies, governments, financial technology firms and corporations. The transaction would provide a platform to compete with industry giants like Intercontinental Exchange and Michael Bloomberg's namesake financial data empire.



Source: LSEG presentation

Bloomberg has long been the preferred terminal of choice for finance professionals; but is renowned for being expensive. That level of expense – around US$24,000 per terminal for a single user – provides an opportunity for challengers trying to unseat the incumbent or at least chip away at the (profitable) user base.

Bloomberg reportedly has about 33% market share, while Refinitiv's lower priced Eikon software has about 22% market share, according to a report from Burton Taylor Consulting cited by The Financial Times.

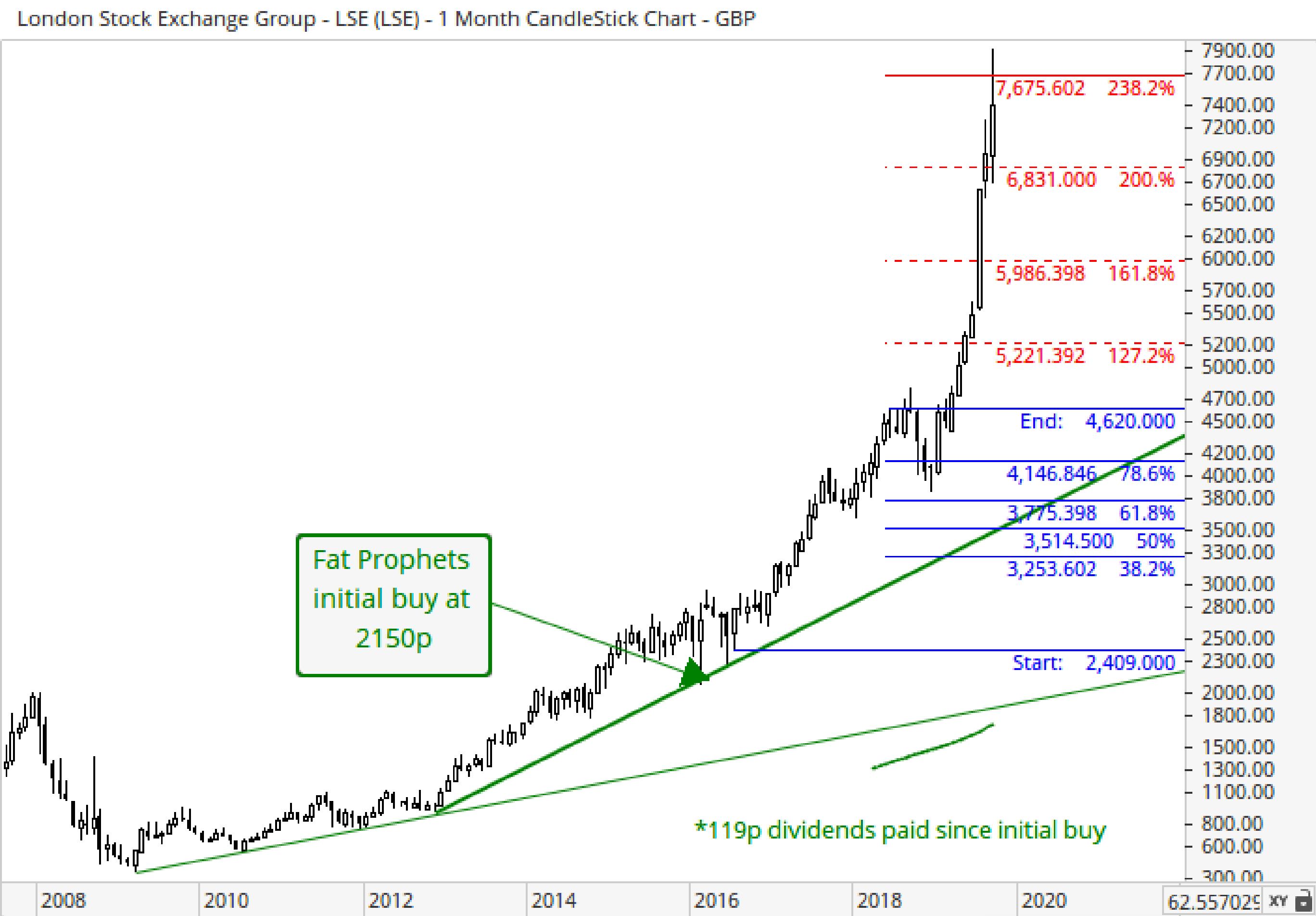
There is much more to the Refinitiv business than just its Eikon terminals, as its trading venues business includes the Tradeweb trading platform (Refinitiv owns a majority interest of Tradeweb) and the FxAll currency and Matching platforms, among others, with average daily trading volume of over US$400 billion in foreign exchange and US$500 billion in fixed income.

Hence a successful acquisition would put it in the same ballpark for scale as giants like Intercontinental Exchange, which owns the New York Stock Exchange. LSE would also be able to use Refinitiv's broad and deep data and analytics to develop new products to slot into other areas of its business.

LSE said, "*The combined business would create a leading, UK headquartered, global financial market infrastructure provider with significant multi-asset capital markets capabilities, a leading data and analytics business and a broad post-trade offering, well positioned for future growth in an evolving landscape.*"

The deal will face a close look from regulators, but we would expect it to proceed, with the possibility of some asset sales. The deal would also require shareholder approval and on that front, we also expect a green light. Under the transaction terms, LSEG would continue to be chaired by Don Robert and led by David Schwimmer, Chief Executive Officer, with David Warren as Chief Financial Officer.

Integration risks would be significant, given the size of the deal, debt load and the complexity.



Summary

HKEX has tried to crash the party with a proposal to acquire LSEG, but this has been rejected by the London Stock Exchange Group Board for the reasons discussed above. HKEX has said it will continue to engage with LSEG shareholders, but we do not expect this transaction to proceed.

We believe the strategic rationale for the potential Refinitiv deal to be sound and agree with the direction towards data and analytics LSEG is taking. <u>However, given the additional lift in LSEG's stock price following the HKEX proposal, rapid appreciation of the LSEG shares in 2019 and elevated valuation on this optimism, we recommend Members take some profits off the table to lock them in at this juncture.</u>

Accordingly, we recommend Members sell-half of London Stock Exchange Group around the current price.