The Deutsche Boerse bid for London Stock Exchange: A clinical study of how it was thwarted by shareholder activism

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Abstract

This case study examines the strategy which allowed a small activist shareholder to thwart a takeover bid by Deutsche Boerse for the London Stock Exchange. Primarily the case marks the emergence of shareholder activism in a country that offers only limited power to the shareholders of corporations. In Germany, the Corporate Governance regime requires stakeholder interests to be maximised rather than the sole interests of shareholders. This paper chronicles the shareholder actions that forced the takeover bid to be abandoned and seeks to provide an understanding of the motivations behind the activists' campaign and the process by which they were able to overcome difficult odds and win their campaign. In this respect, it provides a useful insight into the processes used by relatively small investors to thwart a takeover offer and topple some powerful corporate executives. Furthermore, the case illustrates how a simple issue such as the strategic logic or the value creation potential of a takeover bid can rapidly spiral to become a campaign centred on deeply rooted governance concerns at target companies. Thirdly, the case sheds light on the importance of communication between management and shareholders especially when corporate decisions of great strategic import, such as a takeover, are being implemented. The globalisation of stock markets is empowering shareholders to assert their rights and their activism is driving corporate governance regimes towards greater convergence and recognition of the primacy of shareholder interests. Overall, the case raises a number of important issues regarding the corporate governance regime in Germany, the challenges posed by overseas investors, and the international convergence of corporate governance regimes.

I. Introduction

Shareholder activism is the strategy through which shareholders in a company influence the governance structure, strategic direction and/or the behaviour of target companies so as to better serve shareholders' interests. Shareholder activism in Europe is still in its infancy and doesn't operate with the sophistication found in the United States where the strategy has been deployed for over twenty years. Until recently, activism in Europe was largely limited to the UK because of its many common, 'Anglo-Saxon' characteristics shared with the US. Activists rarely targeted corporations based in Continental Europe. Weak shareholder rights, entrenched managements or concentrated ownership structures have proved formidable obstacles to such activism.

However, the resignation of the CEO and the Chairman of the supervisory board of Deutsche Boerse following the collapse of its takeover bid for the London Stock Exchange in 2005 provides a dramatic illustration of the emergence of shareholder activism in Germany. The German governance regime[2] dilutes much of the power that shareholders enjoy in other developed governance regimes by emphasising stakeholder, rather than merely shareholder, rights. In the case of the Deutsche Boerse bid this regime and its philosophical underpinning were challenged. What facilitated this challenge was the change in the ownership structure of Deutsche Boerse since its stock market listing. The 'Anglo-Saxon' funds that had bought substantial stakes in the company brought their robust activist attitudes and strategies honed in the US and UK markets. They introduced a new mechanism for triggering governance changes to the German market. When Deutsche Boerse listed on the Frankfurt exchange in 2001, the directors clearly misunderstood the power shift that would occur once foreign investors became its owners.

An analysis of the Deutsche Boerse bid and its collapse is interesting for a number of reasons. Primarily, the case marks the emergence of shareholder activism in a country that offers only limited power to the shareholders of corporations. In this respect, it provides a useful insight into the processes used by relatively small

[2] The German governance regime is explained in depth in the following section.

investors to thwart a takeover offer and topple some powerful corporate executives. The case shows how different classes of shareholders in the company formed a coalition to force through their desired changes. Secondly, the case illustrates how a simple issue such as the strategic logic or the value creation potential of a takeover bid can rapidly spiral to become a campaign centred on deeply rooted governance concerns at target companies. Thirdly, the case sheds light on the importance of communication between management and shareholders especially when corporate decisions of great strategic import, such as a takeover, are being implemented. Fourthly, the globalisation of stock markets is empowering shareholders to assert their rights and their activism is driving corporate governance regimes towards greater convergence and recognition of the primacy of shareholder interests. Overall, the case raises a number of important issues regarding the corporate governance regime in Germany, the challenges posed by overseas investors, and the international convergence of corporate governance regimes.

This paper chronicles the shareholder actions that forced the takeover bid to be abandoned, as well as the subsequent board changes at Deutsche Boerse. It seeks to provide an understanding of the motivations behind the activists' campaign and the process by which they were able to overcome difficult odds and win their campaign. The paper raises issues surrounding the governance of German companies and the relative balance of power between managers and shareholders. The case also illustrates the globalisation of the concept and practices of shareholder activism.

The remainder of the paper continues as follows. In Section 2 the corporate governance regime in Germany is outlined, along with a discussion of shareholder activists. In Section 3 the parties involved in the merger are described along with an outline of the merger. Section 4 analyses the intervention by shareholders and the implications it raises for governance issues in Germany. Section 5 draws conclusions and highlights the implications of the Deutsche Boerse example for corporate governance in general.

II. German Corporate Governance and Shareholder Rights

A. Corporate governance overview

"Corporate governance deals with the ways in which suppliers of finance to corporations assure themselves of getting a return on their investment", (Shleifer and Vishny, 1997). The corporate governance structure specifies "the distribution of rights and responsibilities among different participants in the corporation, such as, the board, managers and shareholders, and spells out the rules and procedures for making decisions on corporate affairs. By doing this, it also provides the structure through which the company objectives are set and the means of attaining those objectives and monitoring performance" (OECD, 1999). Thus, governance standards are of fundamental importance. Poor governance can have a direct drain on the performance of a corporation.

Corporate governance problems usually arise when managers of a company fail to act in the interests of the shareholders. This occurs when they both fail to operate the business as efficiently and profitably as possible and hence fail to maximise shareholder value, or when they follow their own self-interests to the detriment of the firm, such as empire building acquisitions.

Academic research in the US indicates that improved governance standards lead to better economic performance. Gompers et al (2003) empirically investigate the link between good corporate governance and the firm's equity value. They report that firms with strong shareholder rights have an average annual abnormal return of 8.5% over the period 1990 to 1999. They also identify an improvement in firm value of 11.4% for each 1 percent increase in shareholder's rights. Malatesta and Walkling (1988) and Comment and Schwert (1995) find that governance changes aimed at anti-takeover protection produce negative abnormal returns to shareholders. Cremers and Nair (2005) find that over the period 1990-2001, firms that improved their governance generate annual abnormal returns of between 10 and 15% per year. Core et al (2006) conduct similar analysis using two portfolios called Democracy and Dictatorship and find that the Democracy portfolio (the portfolio of firms with good governance and respect for shareholder rights) consistently outperforms the Dictatorship (governance regime that ignore shareholder rights).

Several papers have attempted analysis of the impact of governance standards on firm performance in Europe. Drobetz et al. (2003) study the period 1998-2002 and find an excess return of 16.4% when following a long term strategy of improved corporate governance. De Jong et al. (2002) study the Netherlands and reveal a positive relationship between governance standards and firm value. This result is also reported by Black (2001) in a study of Russian governance standards. Black et al (2003) with an analysis of 526 Korean firms also find that by improving governance standards from worst to best practices, the firms exhibit a boost in Tobin's Q[3] of 42 percent. Overall, these studies establish a strong link between good corporate governance and firm value or superior shareholder returns.

B. Corporate Governance in Germany

Monitoring the managers – the corporate board

Corporate governance in Germany is markedly different from that in the UK where the London Stock Exchange is based or the US. Governance practices in Germany stem from the German Stock Corporation Act (1965), German Codetermination Act (1976) and the German Corporate Governance Code (2005)[4]. Governance in Germany is founded upon the stakeholders model in the US or UK or in other 'Anglo-Saxon' countries the shareholder model whereby the shareholders, as the ultimate owners of the firms, are deemed to hold power and the shareholders' expectation of adequate financial return is supposed to drive managerial efforts. The governance regime is designed to ensure alignment of shareholder expectations and managerial behaviour. Under the German system as prescribed in the German Corporate Governance Code (2005), the managers must act in the interests of shareholders, but must also take into

[3] Tobin's Q is the ratio of the market value of the firm to its assets. A value of one indicates that the market value of the firm equals the replacement cost of the firm's assets.

[4] The German Corporate Governance Code as amended in 2005 is a voluntary code that utilises a comply or explain principle similar to that found in the UK Combined Code on Corporate Governance (2003).

account the needs of the employees of the company as well as the wider community. It means that the power of the shareholders is somewhat diluted.

A typical German corporate board is structured with two tiers - an executive board and a supervisory board. The executive board is responsible for running the company and representing it in day to day operations. The executive board is relatively autonomous but must seek the approval of the supervisory board for fundamental business decisions. In contrast, in the UK and the US, the board is unitary and includes the chief executive, other executive directors and non-executive directors.

The supervisory board is responsible for both appointing and monitoring the executive board. It approves the financing and investment decisions made by the executive board which are likely to have a major impact on the company. The supervisory board consists of representatives of both the shareholders and the employees of the company. In many organisations, other stakeholders, such as the community, are also represented. This broad representation reflects the stakeholder model of German capitalism. As a result, shareholder representation can account for as little as a third of the members of the supervisory board. Under these circumstances, shareholder power to influence the supervisory board leave alone the executive board is limited. The directive given to the supervisory board by the German Governance Code (2005) is that they must act in the best interests of the company. Deutsche Boerse is different in that the majority of its supervisory board is made up of shareholder representatives, the remainder being representatives of the employees (See Table 4).

Shareholder rights

Shareholder rights and the means of enforcing them are important aspects of corporate governance. In Germany, shareholders are not as protected as they are in regimes such as the United Kingdom. The rights of German shareholders according to Goergen and Renneboog (2003) are summarised in the table below.

Table 1 - Comparison of shareholder rights in Germany and the UK

	Germany	**UK**
Ownership Disclosure - Minimum level - Minimum level to reveal strategic intent	 5% None	 3% 15%
Dual class Shares	Non Voting shares exist	No non-voting shares
Voting limits	5% - 10% level common before 1998. Only exist if entrenched in Bye-Laws	None
Voting Rights - Casting votes	 Physical Presence at AGM required. Only shareholders holding above 5% can call meeting	 Fax, mail or internet but in person for vote by show of hands
- Registration of votes	Deposit with notary, depository bank or company	No deposit of shares required
- Vote on large issues	Supervisory Board not obliged to offer shareholder vote	Large deals require shareholder approval under LSE rules
Minority Protection	Weak protection	Strong protection
New issues	Rights issue	Rights issue

As the above summary shows, German shareholders enjoy only limited protection when compared to their counterparts in the UK. When considered with their inability to directly influence the executive board, they only have a limited say on the direction that the company takes. It is important to note that under German Law, the supervisory board is not obliged to offer a vote to the shareholders on major decisions such as a takeover as it has the authority to approve such a decision. Therefore, even when shareholders are apprehensive about value destruction from a takeover their ability to prevent it is very limited.

C. Shareholder Activism in Europe

Traditionally, shareholders have taken a passive role in the public companies in which they invest. However, the past three decades have seen a new breed of investors, the raiders and activist funds, emerge from the shadows of passive institutional investors. Unwilling to tolerate poor management practices and financial underperformance, US institutional funds have also become very vocal in their criticism of underperforming companies. Shareholder activism is now a widespread investment practice in America, and some fund management institutions e.g. CalPERS operate specialist active or focal funds to pursue these policies. The aim of shareholder activism is to force underperforming companies to change their strategic choices or the governance structure or the executive reward system. The intention is to force through changes that will reverse the underperformance and improve investment returns for the shareholders.

The spread of shareholder activism from the US to Europe has been slow and uneven across countries. In the UK, a number of British activist investors now operate, notably Hermes Asset Management and Insight Investments. The close similarities between the UK and US markets have also attracted a number of US funds to invest in the UK, bringing with them their interventionist attitudes and practices. The UK shareholding is more concentrated among institutions than in the US. Institutional shareholders own two thirds of all listed equities Despite such concentration of institutional ownership in the UK active engagement with investee firms is a recent phenomenon in the UK.

However, the expansion of these funds into continental Europe has been difficult. In Germany, widespread share ownership has only happened since 1997. The German corporate ownership structure is very much based on controlling block holders that are usually large companies, banks or powerful families. Goergen and Renneboog, (2003) find that 85% of listed German companies have a shareholder that controls in excess of 25% of the voting rights. In the UK, over 90% of listed companies have no such shareholder. Institutional ownership of listed companies is less than 20% in Germany, compared to over 60% in the UK. So institutional investors have until recently adopted a lower activist profile than in the UK. However, this picture is rapidly changing as more and more US and UK funds look to Europe, in particular Germany as Europe’s largest economy, as a source of high investment returns and portfolio diversification.

Activism - the *modus operandi*

The differences in governance and ownership structure, and the different stakeholder perspectives between Germany and the US/ UK make many of the American activist policies difficult to sustain in the German setting. The three main activist strategies used in the US are outlined in the following table (Karpoff (2001)):

Table 2 - Main activist techniques utilised in the US

Type of Activism	Approach
Shareholder Proposal	Widespread use in US - over 1000 proposals submitted each year by shareholders. Very aggressive form of activism
Public Pressure	"Focus Lists" published by major activist shareholders such as CalPERS or TIAA-CREF. Attempt to 'name and shame' management into appeasing shareholders. Criticism of management by US investors in press widespread.
Private Negotiation	Behind closed doors' communication between investors and company management. Mainly unrecorded. Often used in conjunction with proposals and public pressure

In the UK, shareholder proposals are not as popular as they are with American investors. The relationship between UK investors and boards is much more cordial than in the US[5] and as such private negotiation is the favoured 'engagement'[6] route. Public pressure is also used to a degree but this tends to be statements in the press rather than the publication of lists of companies that will be subject to activist pressures.

Impact of activism

Evidence on the impact of activism on target firms is conflicting and depends upon the issues targeted and the methods used. Activism by proposals tends to have a negative effect on shareholder value due the negative signals that it sends to the market (Karpoff, Malatesta and Walkling (1996); Wahal (1996); Huson (1997); Del Guercia and Hawkins (1998); Prevost and Rao (2000); Faccio and Lasfer (2001)).

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[5] *IMA Engagement Survey 2005,* Investment Managers Association.

[6] UK investors prefer the term engagement to activism as they feel activism is too much of an adversarial term.

However, activism through focus lists or private negotiation often leads to value creation (Wahal (1996); Akhigbe, Tucker and Madura, (1997); Opler and Sokobin (1997); Martin, Kensinger and Gillan (2000); English, Smythe and McNeil (2002); Nelson (2005)).

Engagement usually has very little impact on target firms' operations. There is little evidence of significant changes in operating performance, whether measured by accounting or operating efficiency variables (Karpoff, Malatesta and Walkling (1996); Prevost and Rao (2000); Smith (1996); Strickland, Wiles and Zenner (1996); Opler and Sokobin (1997); Carleton, Nelson and Weisbach (1998); Del Guercia and Hawkins (1998)). There is a small impact on restructuring efforts by target firms, but there is no real change in capital expenditure (Smith (1996); Huson (1997); Martin et al, (2000)).

Board composition is one area in which shareholder intervention has positive effects. Boards generally become more independent and diverse once intervention occurs (Akhigbe, Tucker and Madura, (1997); Carleton, Nelson and Weisbach (1998); Girard (2000); Wu (2002)). However, there is little evidence of significant changes in CEO turnover rates or executive compensation structures as a result of activist pressure (Smith (1996); Karpoff, Malatesta and Walkling (1996); Huson (1997); Opler and Sokobin (1997); Perry and Zenner (1997); Del Guercia and Hawkins (1998); Girard (2000)).

An underlying theme is also present in some articles. Activism targeted on some minor issues appears to be used as a proxy for larger issues which are harder to target (Johnson and Shackell, 1997). They might also be used to test the responsiveness of the target executives.

The activism under analysis in this paper differs from normal shareholder intervention. As previously explained, shareholder intervention has traditionally occurred where flaws in the corporate governance structure of the firm exist. Alternatively, activists have target the strategy of strategic decisions (dividend payments, executive compensation, etc) undertaken by firm management in order to address underperformance at the targets. However, activists are now actively starting to target transactions such as takeover bids. This occurs where the activist feels the target is not a good strategic fit for the existing business, or where the offer price does not represent value for money.

D. Shareholder value performance of acquirers and activism

The corporate control market is regarded as a mechanism for removing underperforming managers. As Jensen and Ruback (1983) state, "the takeover market is a market in which alternative managerial teams compete for the rights to manage corporate resources." The corporate control market acts as an external threat as underperforming managers can be substituted by better management teams via an acquisition (Cyert, Kang and Kumar, 2002). But the disciplinary effect of this market may be weak. The outgoing executive management of the acquired firm may have received excessive compensation for loss of office or other inducements to agree to a takeover even if did not serve the target company shareholder interests.

Empirical evidence on the shareholder value outcomes of mergers is mixed, although most research finds negative returns to acquirers. In the US over the period from 1980 to 2000 a number of studies have analysed the impact of takeovers on returns from both targets and acquirers. Loderer and Martin (1990) found that only 49% of tender offer acquirers and 54% of mergers produced positive returns for acquirer shareholders. The target shareholders generally obtain a positive announcement effect ranging from 12% to 29%, while the bidders also obtained a small abnormal return ranging from 1% to 4% upon announcement of an intended takeover (Magenheim and Mueller, (1988); Jarrell and Poulsen, (1989); Loderer and Martin, (1990)).

However, the post acquisition performance is not good. In the majority of cases acquisitions proved to be value destroying, with negative abnormal returns ranging from -1% to as high as -28% for a period up to 5 years post acquisition (Mandelker, (1974); Langeteig, (1978); Franks et al, (1988); Agrawal et al, (1992); Agrawal and Jaffe (2000); Rau and Vermaelen, (1998)). These large negative returns are often due to poor target selection, excessive takeover premium or poor post acquisition integration or a combination of all three. Post acquisition, innovation and new product development often decreased dramatically while impediments to innovation often increase post acquisition. Accounting performance often declined post acquisition when measured by operating income or return on equity (See Sudarsanam, 2003, ch.4 for a review).

In Europe, the picture painted by US acquisition research is largely repeated. Upon announcement of the intended acquisition, UK target shareholders usually receive a significant announcement abnormal return ranging from 22% to 38%. However, in the same deals, bidder shareholder returns suffer small negative returns between -1% and -6%, or at best no impact on the share price (Franks and Harris, (1989); Sudarsanam et al, (1996); Higson and Elliott, (1998); Sudarsanam and Mahate, (2003); Goergen and Renneboog, (2003)). Over the long term, the negative returns incurred by bidder shareholders are much larger. For the period up to 5 years post acquisition, negative returns range from -5% to -18% (Franks and Harris, (1989); Limmack, (1991); Gregory, (1997); Sudarsanam and Mahate, (2003)).

In continental Europe, acquisition outcomes are largely similar. Target shareholders obtain significant abnormal returns, while bidder shareholders suffer negative returns associated with takeovers. European cross-border acquisitions perform equally poorly in terms of shareholder value over 4 months surrounding takeover announcements (Goergen and Renneboog, (2003). In Europe, the causes of poor performance of mergers are similar to that of US takeovers.

Governance and acquisition performance

Value destroying takeovers may often be symptomatic of poor governance in bidder firms. Managers may often pursue empire building acquisitions when there is insufficient internal monitoring to ensure managers undertake acquisitions only in the interests of shareholders. Sudarsanam and Mahate (2006) report that poor acquisitions by UK firms lead to significant top management turnover in the following three years. They also find that a robust governance structure e.g. a high proportion of non-executive directors reduces value losses from acquisitions. Poorly structured compensation contracts also tempt managers to undertake highly risky and potentially value destroying (Sudarsanam and Huang, (2006)).

The record of poor performance of the majority of acquisitions evidenced in the M&A literature has sharpened the agency conflict between shareholders and managers and led to some shareholders actively seeking to prevent firms from undertaking acquisitions or to substantially modify the offer terms. In the Netherlands, Knight Vinke Asset Management, an activist fund, engaged VNU NV in a bid to get it to drop its proposed acquisition of IMS Healthcare. Knight Vinke is currently actively pursuing an improvement in the offer terms in the merger between Suez, the French utility company, and French state owned Gaz de France. Bratton (2005) reports a survey of international takeovers in which activists intervened when an M&A was announced. Of the 25 deals analysed only five were completed under the same terms put forward in the original offer. Seven were completed after concessions by the bidder such as price increases, while the remaining thirteen were terminated by one of the parties as a direct result of the activists' intervention.

Hedge funds as activists

There are over 9000 hedge funds in operation in the world but there is no clear definition of the characteristics of these organisations. The SEC defines a hedge fund as any private entity that holds pools of securities or other assets and is not a registered mutual fund. They are able to utilise investment practices not available to traditional mutual funds, such as short selling, and often invest only for short term investment returns. Hedge funds have become very active in corporate governance issues by engaging a target company to induce changes and divesting once the target firm has delivered the necessary changes. They are pre-eminently transaction-driven activists.

Hedge funds have been termed *"swarms of locusts that fall on companies, stripping them bare before moving on"* by Franz Müntefering, head of the SPD, the leading party in Germany's governing coalition in the wake of Deustche Boerse's failed takeover bid for LSE. Not only were hedge funds instrumental in defeating the Deutsche Boerse bid, they have also successfully thwarted other takeovers in Europe as previously mentioned in section II.B.

III. The Proposed Takeover

A. European Stock Exchange Consolidation

Strategic benefits of consolidation

Stock exchanges play an important role in both the domestic and global economies. They are centralised markets in which securities are traded. They raise their revenue from a range of services they offer. Fees are charged for listings, plus an additional annual charge to continue the listing. Furthermore, the exchange provides a trading system in which listed securities can be traded by matching offers and bids. Trading firms are charged a fee for membership of the exchange as well as the trading system offered. Additionally, most exchanges provide additional services for its listed members, such as trading technology and market information that brings in additional revenue. Clearing and settlement services are provided to complete trades undertaken on the exchange. These services are usually provided by third party organisations, such as LGH.Clearnet but the exchange usually has a shareholding and voting interest in them. Markets are regulated by independent national bodies, such as the Financial Services Authority in the UK. They are responsible for ensuring trading rules are adhered to, as well as maintaining investor confidence in the markets.

At the end of 2003, the global market capitalisation of listed equities stood at $31.2 trillion, spread across 54 regulated exchanges. Of the 10 largest exchanges, 5 were located within the European continent. However, even the largest of these exchanges, the LSE with a capitalisation of $2.5 trillion was small in comparison to the NYSE ($11.3 trillion). In North America there were only a handful of international exchanges. However, in Europe, many countries still operate a national exchange. Thus the stock exchange industry in Europe is still fragmented to a large degree.

Consolidation of national exchanges into a pan European ‘super exchange’ would have a number of economic and strategic benefits. The primary rationale for exchange consolidation is to increase the liquidity pool available to market participants. Liquidity exists when both buyers and sellers of equities exist in a single place. If no buyer or seller for a security exists, the security cannot be exchanged and is said to be illiquid. Larger exchanges tend to be more liquid for a number of reasons. Firstly, there are a much larger number and variety of financial securities available in the marketplace. This offers choice to the market participants. Secondly, there tends to be a larger number of market members, such as brokerages or traders, which are willing to trade the securities available. A large umber of participants ensures that there are almost always willing traders for the products available. Finally, an increased liquidity pool allows the exchange to tap into a phenomenon called 'order flow externalities'. The increased liquidity that arises from consolidation attracts participants and issuers from other exchanges. This further enhances the liquidity pool. As a result, trading costs are driven lower (as explained in the following paragraph) and trading becomes more financially attractive. Further business is attracted from outside participants, and a multiplier effect is created whereby the result of the merger is greater than the addition of the two separate entities.

According to McAndrews and Stefanadis (2002), consolidation should produce downward pressure on trading costs for the active participants of the new exchange. A larger exchange in terms of liquidity and participants will dramatically increase the number of trades that occur on the exchange. The cost of operating a trading system is largely fixed now that most exchange systems operate electronically with automatic clearing and settlement services. This cost can be spread more thinly over a larger number of transactions, allowing the fees charged for trading to be reduced. The increased trading will also drive down the spreads offered as the securities are now more liquid with prices responding much more quickly to changes in supply and demand, further reducing the effective trading cost for exchange traders. Furthermore, the economies of scale and scope afforded by such a merger will allow back office and operational efficiencies to be found. The combined exchange will not need two complete sets of operational or support staff and significant cost savings can be made in this regard. Trading platforms are associated with a high fixed cost of development and a reduction in the number of trading platforms that exists not only reduces the aggregate development cost but also spreads it over a much wider number of terminals.

Consolidation will also allow revenue and earnings synergies to be exploited. Despite similarities, most exchanges do not offer identical products to their members. For instance, LSE has a very limited derivatives platform whereas Deutsche Boerse has one of the most advanced systems in Europe. Consolidation should aid the reduction of fragmentation in this industry by reducing the number of parallel systems that exist. This benefit is possible a longer term benefit. There is possibility for revenue stream enhancements by offering a wider range of products. As outlined previously, this should help to attract new business to the exchange as well as improve the existing revenue streams (Harris, 2003).

European Exchange consolidation also has strategic benefits for the member exchanges. The current system of national exchanges is unsustainable in the modern day exchange industry. Advances in technology allow brokerages and investors to easily access other exchanges that were once out of geographical reach. A consolidated European exchange is the only way to compete with the attractive investment opportunities offered by American exchanges. First stage consolidation also places the consolidated exchange at an advantage when subsequent consolidation opportunities occur. For instance, consolidation between Deutsche Boerse and LSE would position it perfectly to attract future mergers with other national exchanges that might be tempted by a linkup with either OMX or Euronext as the industry stands at present. There is also the potential threat of an attempted takeover by one of the American exchanges as they seek to gain access to the European market. Alternatively, they might decide to set up their own European exchange. A consolidates 'super exchange' would be better equipped to fight off such a threat.

Barriers to consolidation

However, consolidation in Europe is faced with a number of barriers. Issuers and investors might prefer the small exchange system that currently exists as they will be better able to serve the diverse range of clientele that exists throughout Europe. Language barriers and information asymmetry could become a factor in a Europe wide exchange. Home country bias exists where investors would prefer to hold their own national firms' equities due to the problems of information and language barriers.

Finally, regulatory regimes differ dramatically across Europe. Several regulatory bodies operate across the European bloc, each with their own set of rules and regulations. Harmonisation of regulations could well be a pre-requisite for successful consolidation in Europe.

Consolidation amongst European exchanges is not a new phenomenon. Euronext had been formed via a merger between the Dutch, French, Belgian and Portuguese exchanges, while OMX consolidated the Swedish, Finnish, Danish, Latvian, Estonian and Lithuanian exchanges into one major market. In the US, the two major exchanges, NASDAQ and NYSE, are consolidating by purchasing the major electronic exchanges, NASDAQ through Instinet and NYSE through Archipelago. However, there are still over 40 exchanges worldwide and trans-continental consolidation may well be the next step.

In May 2000, the London Stock Exchange announced its plans to merge with Deutsche Boerse in a move that would create the second largest exchange in the world behind the New York Stock Exchange. The new exchange group was to be called iX (an acronym for International Exchange) and future plans involved a technical linkup with Nasdaq to create a global stock exchange. At the same time, the Paris stock exchange was outlining plans to merge with Amsterdam and Brussels to create Euronext NV. Euronext undertook the merger as it had been angered at not being involved as part of the iX plans. However, on 29th August 2000, the Swedish technology company OM Group made a hostile takeover offer for the LSE. LSE dropped out of the planned iX deal despite the OM bid failing. LSE’s CEO, Gavin Casey, resigned to be replaced by Clara Furse. Shortly afterwards, LSE was beaten in the race to acquire Liffe (the London International Financial Futures Exchange) by the newly formed Euronext NV.

B. The Exchanges

The London Stock Exchange, Deutsche Boerse and Euronext are the three largest stock exchanges in Europe, as well as some of the largest in world. At the end of 2003, only the New York Stock Exchange, Tokyo Stock Exchange and NASDAQ were larger in terms of equity listing capitalisation. Euronext had been formed through a merger between a number of smaller European stock exchanges, namely Paris, Amsterdam and Brussels, while Deutsche Boerse had developed a strong debt market since German firms often raised new capital through debt securities. A summary of the exchanges is provided in the following table.

Table 3 - Summary Characteristics for European Exchanges

	London Stock Exchange	Deutsche Boerse	Euronext
Key Systems			
Cash Market	SETS	Xetra	Euronext
Derivatives	EDX	Eurex	LIFFE
Clearing	LCH Clearnet	Eurex Clearing	LCH Clearnet
Settlement	Crestco	Clearstream	Euroclear
Employees	519	3,262	2,511
Market Value (£bn)	1.1	2.93	1.63
Market Capitalisation of listed equities (£bn)	1,374	603	1,160
Equities Listed	2,692	866	1,392
Value of Share Trading (£bn)	2,233	676	1,102
Turnover (£mn)	226	836	584
Profit after tax (£mn)	53	145	125
Liquidity Ratio	3.62	1.21	2.02
Leverage Ratio	0.24	0.70	0.34
Assets (£mn)	480	6,0890	1,638

The London Stock Exchange was formed in 1773 but can trace its roots as far back as 1698 when trading took place in a coffee house in London. It is the national stock exchange for the UK. It is the largest of the three exchanges when measured by either listing volumes or listing value. However, it is by far the smallest of the exchanges in terms of its market capitalisation. Despite its small size, it is the least leveraged of the three and has the strongest liquidity.

The size and strength of Deutsche Boerse is surprising given the relatively low number of equities that are listed on its exchange and its relatively young age. It was only formed in 1990. The LSE has benefited from a buoyant market in secondary listings for oversees companies looking to raise finance from European investors.

This therefore makes it the natural target for consolidation by one of the larger exchanges. Both Euronext and Deutsche Boerse have far more widely implemented derivatives trading platforms in terms of Liffe and Eurex. A merger could allow LSE market participants access these platforms and reduce the potential cost to LSE of developing its fledgling system, EDX.

The governance and listing structures on LSE are amongst the most robust and transparent in the world. The likely impact on these regimes could be a determining factor in identifying the eventual acquirer of the London Stock Exchange. A summary of the governance structures is provided below.

Table 4 – Summary governance structures for European Exchanges

	LSE	Deutsche Boerse	Euronext
Board Type	Unitary	Two –Tier	Two - Tier
Board Structure	Independent Chairman, two executive directors, six non-executive directors	6 person executive board. Supervisory Board consisting 21 directors - 14 shareholder representatives and 7 employee representatives. Shareholder representatives mainly selected from traditional German investors – often members of German Banks or other Supervisory Boards	9 person independent Supervisory Board plus 5 person Executive Board
Committees	Remuneration, Audit, Nomination	Audit and Finance, Technology, Personnel, Strategy, Clearing and Settlement	Audit, IT, Nomination, Remuneration , Corporate Governance

Of the three exchanges, both Euronext and Deutsche Boerse operate two tier board structures comprising an Executive Management team and a Supervisory Board. Surprisingly, none of the major institutional shareholders in Deutsche Boerse (See table 11) was represented on its Supervisory Board. LSE operates a unitary system with both executive and non-executive directors. Clearly, the governance structure of either of the two European rivals is at odds with that of the LSE and the stakeholder approach might not find favour with the shareholders or members of the LSE.

C. The offer

On 13th December 2004, the CEO of Deutsche Boerse AG (DB hereafter) announced that it was seeking to purchase the London Stock Exchange and made a bid priced at 530p a share in cash for the company. The bid valued the LSE at £1.3bn, a 23% premium to the closing price of LSE shares 2 days earlier. However, the LSE responded that the bid undervalued the company and rejected it straight away. Over the subsequent 3 months, the bid was kept open. The following table summarises the various takeover-related announcements.

Table 5 – Public announcements and other events during the offer period

Date	Event	LSE Share Price (Pence per share)
27th November 2004	LSE shares rise by 8.2% in a week to 413.5p a share on rumours of a 450p a share offer from DB	413.5
12th December 2004	LSE shares rise further 5% on takeover rumours.	430
13th December 2004	LSE opens discussions with DB on possible takeover	540
	DB makes £1.35bn, 530p a share cash offer for LSE. Offer is at a 23% premium to closing price 2 days earlier	
14th December 2004	LSE rejects DB offer as too low	544
	Euronext signals interest in LSE in wake of rejection of DB’s bid.	
	LSE announces it will open discussions with DB and tries to tempt other suitors to enter an auction.	
15th December 2004	European Commission announces it would look into any proposed deal to acquire LSE by one of the other 2 main exchanges.	551
	LSE shares rise on expectations that a revised offer will be made. Rumours of potential offer from Euronext fuels city sentiment that the offer will be sweetened	
18th December 2004	DB offers Clara Furse seat on new combined board on condition that LSE accepts the £1.3bn bid.	556
20th December 2004	LSE announced that it has received a preliminary approach from Euronext and would enter into discussions to obtain the full terms of the offer	579.75
21st December 2004	LSE announces talks with DB and Euronext will continue	575
6th January 2005	DB demands LSE sets out detailed timetable for takeover negotiations given its mounting frustrations at the lack of progress in the bid	583
8th January 2005	Euronext meets LSE and outlines plans for a merger between the two exchanges	584
17th January 2005	DB Supervisory Board backs its CEO in wake of pressure from its investors to call off the deal.	580
27th January 2005	DB formally reveals details of a conditional 530p a share offer for LSE	579
9th February 2005	Euronext plans to offer a substantially improved offer for LSE above that offered by DB	572

Table 5 indicates the lengthy discussion phase that occurred between the London Stock Exchange and its potential suitors. However, no formal bid materialised from Euronext. The LSE share price appreciated dramatically in anticipation of a higher bid by DB to overcome the concerns of the LSE board.

D. Offer Terms and their underlying logic

The conditional offer from DB and the potential offer from Euronext are both based on similar value creation strategies which, however, differed in their feasibility and hence credibility. The details of the offers are outlined in the following table.

Table 6 - Expected synergies in the two offers[7]

	Deutsche Boerse	Euronext
Offer Price	530p	Est 600p
Cost Synergies	€75m	€153m
Revenue Synergies	€ 25	€51m
Revenue Dissynergies[8]	€15m	€20m
Trading Fees	-10%	-10%
Other Fees	-10% (IT services)	-10% (IT services)
Total Synergy	€100m	€204m
Clearing and Settlement	LCH.Clearnet Contracts in exchange for fee reduction	No change

As the above table illustrates, both DB and Euronext look to derive significant synergies from a unified IT infrastructure, head office costs and revenue increases as a result of a wider exchange with larger trading volumes. However, Euronext expects to raise synergies double those of its German rival. Industry opinion (BNP Paribus and Bear Stearns) is mixed on this staggering claim, as outlined in a following section. A significant difference between the two proposals is that DB would establish LCH.Clearnet as the sole provider of settlement and clearance services. Such a possibility would most likely trigger the attention of the UK or EU competition authorities on grounds of substantial lessening of competition.

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7 Summary taken from Duetshce Bank Analyst Reports

8 Revenue dissynergies are the likely revenue losses due to cannibalisation by the exchanges as a result of the takeover.

Amid concerns regarding corporate governance at the newly formed exchange, DB outlined the executive structure that would be set up should its bid prove successful. Post-acquisition, LSE would have a unitary board consisting of 15 directors (two from LSE, two from DB, eleven independent directors and customer representatives) plus the LSE chairman. This board would be responsible for operational changes, although approval would be required from DB's management board as well. The board members responsible for equities, derivatives and clearing for the new group would operate from London. These plans were outlined to assuage fears that had been raised during the iX merger discussions that the structure of the group would be too centred on control from Germany and would not represent the investors in London. This had been a contributing factor to the collapse of the iX merger negotiations and DB was keen not to make the same mistake twice.

E. Rationale

Both DB and Euronext based their offer terms on similar rationale. They believed that a deal with LSE would provide significant synergies and unlock substantial shareholder value over the long term, mainly through integration of IT systems as well as by attracting more liquidity and listings. Euronext expected to generate over €200m in synergies from the takeover in the medium term (up to 5 years post acquisition), with long term revenue growth expected to generate significant value in the future. DB was more cautious, expecting only half the synergies and making more restrained growth estimates.

Euronext's higher synergy expectation emanated from its London-based operations. A merger between the two companies would allow it to rationalise its operations with those of the LSE and dispose of parallel IT systems. Euronext had offices in London which would be closed under the plan. It also had a significant clearing business in the City (of London), as LCH.Clearnet was the clearing partner for both exchanges. Further cost savings would be made here. Secondly, a merger between these two parties would give Euronext a dominant position in cash trading, IT systems and software sales, three areas that were forecast to experience tightening margins over the longer term due to increased competition from electronic exchanges and specialised technology partners.

Interestingly, DB did not intend to follow the same route as Euronext and planned to continue a two exchange system. Euronext planned to unify the two exchanges and operate one integrated trading platform. This was the source of much of the extra synergy value that Euronext expected to unlock.

The LSE was supportive of a potential acquisition by one of its larger European counterparts. It believed that a merger of this type would allow the newly formed bourse to successfully compete with the larger American exchanges for both listings and liquidity. Economies of scale attributable to a larger exchange would also allow lower trading costs and innovation of exchange services to generate higher revenue. LSE also felt that an offer at a reasonable price would provide value to all parties involved.

A merger between LSE and a major competitor could also have given LSE access to financial product markets that it was unable to exploit at that time. LSE had no significant derivatives trading system at a time when these products were producing significant revenue streams for other exchanges and its EDX solution was struggling to fill this gap. A merger would allow it to use either Eurex or Liffe and thus allow it to offer derivatives trading systems to its members without the potentially expensive development and implementation costs.

Finally, LSE was seen as the key European player in the fight to attract liquidity from other European and international centres. The combined exchange would be the dominant player in Europe, and the potential to attract further partners from smaller exchanges would be high. Liquidity could be added quickly and cheaply through this expansion process but it was likely to come under the scrutiny of antitrust regulators.

F. Industry Opinion

The proposed merger sparked a lot of debate within the capital markets regarding the merits of such a deal. Analysts, market participants and regulatory bodies all became involved in the unfolding bidding saga.

1. Analyst Recommendations

Analysts were split as to the value that would be realised from a merger of this type. Many analysts could see the potential benefits of a merger between two of the parties involved, but they were not as enthusiastic about the high offer prices being proposed. A summary of analyst opinions regarding the two offers is outlined below.

Deutsche Boerse Proposal

A number of analysts released reports documenting their opinion of the proposed acquisition. A summary of these is provided in Table 7. It is worth noting that Deutsche Bank owned shares in DB and a number of the Supervisory Board members of DB were also board members of Deutsche Bank. This summary shows that the stock market was reacting generally negatively to the DB bid and that it had better options to create value e.g. through a share buy-back.

Table 7 - Summary of analysts' opinions about the DB bid for LSE

Analyst	Date	Opinion
Deutsche Bank	13th January 2005	A 530p a share bid would transfer 80% of synergies to LSE shareholders. Likely trading cost reduction attractive over the medium term
	17th January 2005	530p a share was a fair price. Merger would provide long term strategic benefits.
	27th January 2005	Successful acquisition by DB would generate substantial value for both sets of shareholders
M.M. Warburg & Co	20th December 2004	530p at upper limit of price range at which takeover made financial sense. Above this only strategic benefits left.
	18th January 2005	Acquisition was the worst option and share buyback would have a more positive impact on earnings per share
Credit Suisse	27th January 2005	530p a share significantly overvalues LSE and would destroy value. Share buyback most prudent value creation strategy. High leverage would be required to make an offer at this price.

Euronext Proposal

As highlighted earlier, Euronext didn't explicitly indicate a likely offer price for LSE. Industry Insiders (Bear Stearns) did however expect it to be higher than the 530p offered by DB, with the possibility of a final price in excess of 600p a share. The synergies for Euronext, amounting to double those identified by DB were seen as aggressive by many analysts (Citigroup), but not impossible (ING). Euronext didn't contact LSE with a preliminary proposal until early February 2005, almost 2 months after it had declared that it was considering a rival bid. Table 8 summarises the analysts' opinions about the Euronext bid compared to DB's. It is clear that while analysts were divided about the merits of the bid, Euronext's synergy estimates were seen as more credible and supportive of a higher potential offer price than DB. If DB and Euronext were to enter a bidding war for LSE, DB, on winning, was likely to suffer from the winner's curse more grievously.

Table 8 - Summary of analysts' opinions about the Euronext potential bid

Analyst	Date	Opinion
ING Financial Markets	8th February 2005	Merger was a 'unique opportunity to add momentum to EPS growth'. Cost synergies reasonable up to 700p but bid price likely to be similar to DB's
Bear Stearns	9th February 2005	Euronext proposal credible and Euronext likely to bid around 650p. Bid of around 640p likely to increase Euronext's share price, but would destroy value at DB
Citigroup	9th February 2005	Maintained Euronext sell rating. Synergies outlined in proposal unlikely. DB more powerful financially.
BNP Paribus	24th December 2004 12th January 2005	580p a share bid by Euronext would realise £65m of synergies but destroy 7% of Euronext's value. Bid by either bidder would destroy value.
SG Equity Research	2nd March 2005	Euronext's high potential offer price and synergy estimates make it likely to succeed in a bidding war. Probable acquisition price 600p.

2. Response to bid of industry associations and regulators

The merger proposal sparked debate amongst industry bodies within the city regarding the probable implications of the acquisition of the LSE by an overseas bidder. Amongst the first to raise their concerns was the Association of Private Client Investment Managers and Stockbrokers. It was unhappy that LSE was likely to fall into overseas ownership and felt that a combination of two of the largest exchanges might have an adverse impact on competition and trading conditions for members of the exchanges. This view was later supported by the companies listed on the Alternative Investment Market (AIM) because of fears about the regulatory changes foreign ownership might trigger. The regulatory regime in the UK was one of the major contributing factors that had made the LSE the main market for small company stock market listings. Different regulatory structures in Germany or France might adversely affect small companies that list on AIM. The Primary Market Association, which represented investment banks that issued securities such as HSBC, Deutsche Bank and Morgan Stanley raised concerns that DB owned the Clearstream settlement business which could lead to a conflict of interest and uncompetitive pricing. These sentiments were echoed by investors in LSE who were worried that ownership by DB would stifle competition and lock them into agreements with the DB's own clearing and settlement services.

Some bodies raised concerns that the regulation of the London market would be conducted from outside of the UK as well as over the wider implications for the regulatory regime in general. The Committee of European Securities Regulators (CESR) stated that the LSE takeover would make markets more difficult to regulate, while the Association of British Insurers (ABI) stated that regulation of the LSE should be conducted by a UK body as the confidence in the regulatory environment was one of the cornerstones upon which the LSE stood. The Financial Services Authority (FSA), the existing regulator of the LSE stated that the DB bid for LSE would have wider implications for the regulatory regime in respect to the impact on the financial markets as a whole. It stated that further investigations were required. It argued that the LSE must be run from London and not from an overseas centre.

G. Anti trust and regulatory concerns

The proposed acquisitions by DB and Euronext of LSE were referred to the Competition Commission (CC) on 29th March 2005 by the Office of Fair Trading (OFT) for an investigation of the competition implications. The CC completed its enquiry and issued its final report on 7th November 2005. The CC enquiry concluded that the merger would not lead to a substantial lessening of competition (SLC) in the area of listing services. The inquiry found that little or no competition existed between the three exchanges in this area and therefore a merger would do little to lower competition.

The second area of focus was the services offered by the exchanges in derivatives trading. LSE's presence in the derivatives market was minor through its EDX subsidiary that mainly trades Scandinavian products. Eurnoext offered derivatives trading services though Liffe, and DB through Eurex. Acquisition of LSE by either party would not lead to a SLC as there is little or no competition incumbent in this area. The CC raised concerns that a successful bid for LSE by DB would lead to a SLC in on-book equities trading services in the UK. However given the competition from other exchanges the potential for fee rises was remote. The CC found that in their present form, both proposals had the potential to harm competition on the LSE in respect of clearing services. To counteract these issues, it provided a number of remedies which included Euronext divesting its ownership of LCH.Clearnet or both parties committing to ensure that potential competitors to Eurex or LCH.Clearnet were able to easily gain access to the LSE.

The merger proposals gained conditional approval from the CC under the proviso that the eventual winner would undertake measures to limit or prevent a substantial lessening of competition in the area of clearing services. The CC also stated that a newly consolidated exchange would need to be carefully monitored by regulators to ensure that it didn't abuse its dominant position.

Concern was raised amongst LSE members and other industry bodies regarding the likely regulation of a combined exchange. An FSA statement in February 2005 considered the possibility that the new owner of the exchange would operate the LSE from its existing headquarters outside the UK. However, the FSA believed this to be remote, and in any case regulation of the LSE would still be conducted from London. This view is supported by both bidders who offered assurance that the exchange would continue to be operated and regulated from London if they were successful.

The effect of the CC enquiry was to prolong the uncertainty over either bid while at the same time highlighting the continued monitoring of the merger entity to prevent abuse of dominance. There were also serious concerns felt by UK regulators and members of the LSE and companies about possible adverse effects of any dilution of regulatory oversight because of the change of ownership to a foreign firm. These concerns along with much scepticism over the value creation potential of the two bids provided the backdrop to the shareholder campaign against the DB bid.

IV. Shareholder Intervention

Obtaining regulatory approval was seen as the major stumbling block to a potentially successful bid to acquire the London Stock Exchange. However, DB had not envisaged a shareholder revolt over its takeover proposal. Under German law, there is no obligation for German companies to consult their shareholders on any acquisition plans that they sought to implement. The initial offer proposal was made to the LSE on 13th December 2004. However, the shareholder's didn't air their concerns until a month later, when on 16th January 2005, a small hedge fund based in London (TCI) called for the management of DB to drop the acquisition plans and consider alternative ways to generate value for shareholders. Over the coming weeks, Atticus Capital, Fidelity Investments and Merrill Lynch, amongst others, joined TCI in voicing their disapproval of the offer. Not only did they manage to defeat the merger plans, but they also succeeded in forcing the resignation of two of the leading executives at the German exchange.

A. Who were the activists?

The shareholder intervention against the planned acquisition came from two sources; hedge funds and mutual funds. All of the activists were foreign investment companies, mainly based in either Britain or the United States. At the time of the activist intervention, foreign investors held over 90% of the issued equity capital in Deutsche Boerse. Only 3 years prior to the acquisition bid, German investors had held over 65% of the shares as illustrated in the following tables.

Table 9 - Proportion of Deutsche Boerse shareholders by region

	End 2001	End 2004	End 2005
Germany	68	35	7
US/UK	24	50	77
Other	8	15	16

At the time of the last merger attempt in 2000, German shareholders held two thirds of the equity in the company. These would mainly have consisted of wealthy German families, or German corporations. However, the power shift to UK and US institutional investors brought with it a different type of owner. Interestingly, DB's supervisory board characteristics did not match the change in shareholder nationality. The major institutional shareholders in DB (as at 1st March 2005) are listed below.

Table 10 - Major institutional shareholders in Deutcsche Boerse

Institution	% of Shares	Country of Origin	Type of Investor
TCI Fund Management	5.8	UK	Hedge Fund
Atticus Capital	5.4	US	Hedge Fund
Capital Research	4.9	US	Mutual Fund
Fidelity Management	4.4	US	Mutual Fund
Union Investments Privatfonds	4.1	Germany	Mutual Fund
Harris Associaites	2.6	US	Hedge Fund
Pioneer Investment Management	2.2	Ireland	Hedge Fund
Merrill Lynch	2	US	Investment Bank
Helaba Invest	1.9	Germany	Bank
Norges Bank	1.2	Norway	Bank
Thornburg Management	1.1	US	Mutual Fund
Nordea Bank	1.1	Luxembourg	Bank
Henderson Global	1	UK	Mutual Fund

A description of the main activists in each category is outlined below.

Hedge Funds

The Children's Investment Fund Management (TCI) was formed in 2003 by former money manager Christopher Hohn. The $3bn hedge fund operated mainly by taking large bets on Asian and European equities. The fund took its name from the children’s charities to which it donated 0.5% of assets under management on an annual basis. In 2005, TCI generated an impressive return in excess of 40% which compared very favourably to the 3.9% generated by the S&P Hedge Fund Index. On the back of this performance the fund was awarded the Fund of the Year award by *EuroHedge* as the top performing hedge fund in Europe. The fund actively engaged with all of its investee companies when it felt that there was additional value to be unlocked. TCI threatened to target the management of the Korean cigarette manufacturer, KT&G, after airing its disapproval of the terms of a share buyback scheme. Policies such as these and the intervention at DB have given the fledgling fund a reputation as a leading light for the activist cause. At the time of the takeover, TCI held approximately 8% of the shares in DB.

Atticus Capital is another hedge fund that joined TCI in voicing its unhappiness at the acquisition plan. The US fund, managed by David Slager announced its opposition the day after TCI, and became increasingly vocal as the saga continued. Atticus held 4% of the issued share capital at the time of the takeover battle. Harris Associates, a hedge fund based in Chicago was the third hedge fund to oppose the DB’s plans to buy LSE. It held approximately 4.5% of the equity of the Boerse. This hedge fund had gained a reputation as an activist investor through its high profile interventions at many of the companies that it invested in. In recent times these interventions had been responsible for the removal of the Saatchi brothers from their own company, the pressure on Wal-Mart CEO and in removing the Tompkins CEO after it became apparent his wife and housekeeper were on the company payroll.

Mutual Funds

Fidelity Investments is the world leading fund management business with over $1.2 trillion in assets under management. It is a traditional institutional investor, as opposed to the speculative investment style of the hedge funds listed above. Fidelity is a very passive investor in terms of shareholder activism. It would much rather allow other institutions to act, and in this mould it prefers to free ride on the benefits generated by the actions of other investors[9]. That it chose to join the activist funds in targeting the DB management is a strong indication of the depth of the problems at the German exchange. At the time of the takeover, Fidelity held a 4.5% stake in DB.

Merrill Lynch Investment Management is a similar mutual fund to Fidelity Investments. The US company is a leading institutional investor. It held approximately 2% of the equity in Deutsche Boerse. Merrill was the advisor to LSE and advised it to reject the offer from Deutsche Boerse. Merrill Lynch held 2m shares in LSE until the DB bid, at which time is divested its shareholding in the company.

As can be seen, the activist investors come from both new and traditional investment funds. However, they have different investment strategies and approaches to activism. It is, therefore, interesting to see them joining forces to fight for a common cause as effectively as they did. The hedge funds were the forerunners in the takeover fight, while the traditional mutual funds supported them using their substantial shareholdings and reputations to make management take note of the shareholders opinions.

B. Why did they intervene?

The shareholder revolt at DB initially occurred because of the perception that the offer for the London Stock Exchange would ultimately prove to be value destructive. However, it subsequently also encompassed a number of concerns regarding the

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9 "Funds Ranked on Support for Corporate Governance Proposals in 2005", The Corporate Library Blog, 7th January 2006.

governance of DB, as well as the communication between the Boerse and its shareholders.

1. Proposed Acquisition Value

The shareholders' intervention was initially triggered by their unhappiness over the terms of DB's takeover proposal. TCI felt that the offer price was too high and gave away too much of the synergy benefits to the shareholders of LSE. Under these conditions, it was not the best strategy to unlock value for shareholders and a share buyback would be the most appropriate route. TCI's manager Christopher Hohn said "*repurchase of the company's own shares by Deutsche Boerse would be far superior in value creation.*"[10] The shareholders were in agreement with the principle put forward by DB that consolidation would benefit the long term future for both Deutsche Boerse and LSE. However, they were not willing to support this principle at all costs. DB didn't have the same scale of operations in London as Euronextto extract the same level of synergy benefits from overlap with LSE. For this reason, it could not match the offer price of Euronext's potential bid.

2. Corporate Governance

The continued refusal of the DB executive board to put the takeover to a shareholder vote effectively switched the activists focus from a takeover to the wider issue of corporate governance. Atticus Capital fund manager David Slager said that "*The acquisition appears to us to be motivated by empire building. If they were purely motivated by shareholder interests, they would put the acquisition to a vote.*"[11] Harris Associates told the FT that in its opinion, shareholders should have the right to vote on major acquisitions. This view was also shared by the mutual funds that joined the hedge funds in calling for the removal of the CEO and supervisory board at an extraordinary general meeting.

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[10] "Börse rebel threatens to derail LSE bid", The Guardian, 17th Januray 2005

[11] "Deutsche Boerse faces increasing shareholder opposition to LSE bid – update 4", www.newratings.com, Januray 18th 2005.

TCI aired its complaints that the supervisory board of DB was unrepresentative of the investors of the company and had been set up to aid the CEO in his attempts to buy the London Exchange. Many of the members of the board were selected from German companies or shareholders of DB. This view was given added weight by the supervisory board's continued support of the acquisition plans even after shareholders called for a vote on the merger. Both Fidelity Investments and Merrill Lynch articulated their dissatisfaction with the performance of DB's management for continuing with the acquisition plan in the face of strong investor pressure. The supervisory board was in place to ensure that the management was acting in the best interests of shareholders. However, by allowing the CEO to continue with his proposal, and even back his plans to launch a hostile takeover if the LSE continued to reject its 530p offer price, the activists believed the supervisory board was failing in its basic and fundamental fiduciary responsibility.

3. Communication with Shareholders

The activists were dismayed by their treatment by DB management. Considering they were the effective owners of the company, very little discussion was undertaken with them to attempt to stave off the threat that they presented to the takeover bid. It wasn't until a couple of days before the offer was rescinded by DB, in April 2005, that the supervisory board Chairman attempted to open discussions with investors to allay their concerns and reassure them that the takeover of the LSE would enhance the long term value of Deutsche Boerse. However, by this time the ill feeling felt by the activists was running far too deep. They had already started to call for a complete restructuring of the board structure at the Boerse. A number of the activist investors involved had even commenced a strategy of nominating potential new directors for restructured Executive and Supervisory Boards.[12] The Chairman of the supervisory board, Rolf Breuer, was ultimately responsible for meeting with shareholders and entering into dialogue with them. Unfortunately, it was the CEO Werner Seifert that undertook this responsibility. This was catastrophic for the management of the

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[12] *"Rothschild to lead battle for Börse rebels"*, The Sunday Times, 27th February 2005

Boerse, as he was the person most in favour of the takeover. Fidelity Investments participation in the call for the management to be restructured was caused by a loss of confidence in the governance and management structure in place in DB.

The high acquisition price was merely the catalyst for activist pressure to be directed at DB. Ultimately it was the poor governance and communication problems that caused the investors to become very aggressive.

C. Paths followed

The intervention by the activists was a very high profile process, with much of the dialogue played out in the international press. However, there was a also substantial amount of dialogue that occurred in private that wasn't reported in the media.

The activist's distaste for the merger plan hit the press on 16th January 2005 with a statement from TCI. In it, TCI outlined its objections to the bid and called for a £350m share buyback as an alternative strategy to create value for shareholders. This statement was followed up a day later by a report from Atticus Capital in which it called for the bid to be scrapped and substantial cash returned to shareholders. Further statements by the hedge funds and institutional investors involved were designed to highlight the flaws in both DB's takeover plan, as well as the way it was communicating with shareholders. These 'name and shame' techniques were designed to bring public attention to the issues under scrutiny and force the company management to either completely drop, or substantially alter, the bid to allay the investors' concerns. This public pressure was being applied in conjunction with behind-the-scenes 'private negotiation'. Although information on this strategy is limited, reports suggest that TCI boss Christopher Hohn was communicating with DB management on a daily basis by email and letter. Presumably, the other activist investors were also following a similar path as they tried to make their point to both the DB CEO and its supervisory board.

However, the name and shame policy would appear to have been largely ineffective. DB continued to pursue merger negotiations with LSE and on 24th January 2005 told its shareholders to be patient and that it planned to meet them to discuss the merger at 'the earliest opportunity.' However, the shareholders viewed the statement as a stalling tactic designed to buy the management time to continue discussions with LSE regarding acceptable terms for the offer. DB was continuing to ignore the wishes of its shareholders. As a result, the activist fund TCI increased its equity holdings in the company to just over 5%. It reaffirmed their demands for a share buyback and restated calls for the takeover to be scrapped. The activist investors stated that if the Boerse continued to pursue merger talks, they would hold the supervisory board accountable. The threat appeared to have little impact, as three days later DB made a formal offer for LSE priced at 530p a share. In response to the new offer, the shareholders called for a vote on any merger plans before they are completed. This demand was also rejected by the supervisory board.

The supervisory board's refusal to allow investors a vote on the merger sparked full scale escalation of action by the activist shareholders. On 20th February 2005, the ten largest shareholders in DB announced that they planned to force the resignation of the CEO, Werner Seifert, over his refusal to listen to shareholders concerns. Three days later, DB announced positive annual results but in the process confirmed its intention to continue with the acquisition despite growing unrest amongst its shareholders. As a result, Fidelity Investments called for an extraordinary meeting in which the activists planned to remove not only the CEO, but also the Chairman of the supervisory board, and replace the remaining members. Lord Rothschild, Chairman of Rothschilds Investment Bank, was selected by TCI as the candidate to replace DB's chairman Rolf Breuer should they succeed in ousting him from the company.[13] Lord Rothschild had previously been recruited by the activists to lead their battle again DB management.

On 1st March 2005, DB obtained an injunction through the German courts that would prevent dissident shareholders from completely scuppering its plans to buy the LSE. At the same time, its CEO called for shareholders to engage in peace talks with the

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[13] "*Rothschild to lead battle for Börse rebels"*, The Sunday Times, 27th February 2005

Chairman in an attempt to find a way out of the problem that had arisen. This was rejected out of hand by Fidelity Investments. On 7th March 2005, DB announced it was withdrawing its offer for LSE due to the fierce unrest amongst the majority of its shareholders. The collapse of the bid did not appease the activists. They continued to call for the resignation of the CEO, and on 27th April 2005, Lord Levene resigned from his position on the supervisory board after the CEO refused to bow to the activists demands.

On 9th May 2005, the CEO Werner Seifert announced that he was resigning with immediate effect. At the same time, Chairman Rolf Breuer announced that he would stand down at the end of the year. DB announced that the resignations were accepted in order to sooth the shareholder unrest and to benefit the long term future of the company. The resignations came just 16 days before the AGM in which Morgan Stanley and TCI had submitted a shareholder proposal with the intention to vote off Chairman Rolf Breuer. Hohn's statement highlighted the ill feeling from investors with the role Breuer had played in attempting to force through the takeover. They were also unhappy that Breuer was Chairman of Deutsche Bank and therefore had a conflict on interest as the bank also owned shares in Deutsche Boerse. Furthermore, DB had asked the Office of Fair Trading in London for guidance on the possible regulatory implications of a takeover of LSE and thus the investors thought the board might still be considering a further takeover approach.

Werner Seifert subsequently wrote a book[14] detailing the experiences that he had during the takeover battle. In it, he attacked the activist funds as being short termist in their outlook. Although this accusation could be valid when aimed solely at the hedge funds, the presence of mainstream investment institutions like Fidelity and Merrill Lynch in the activist coalition goes some way to invalidate this accusation. Both these companies operate funds based on long term investment strategies and look for value over the longer term. Their support for the hedge funds indicated the lack of long term value creation that the offer price allowed. Seinfert also claimed to have

[14] Seifert W G and Voth H J, 2006, "*Invasion der Heuschrecken*", Published by Econ. Only available in German

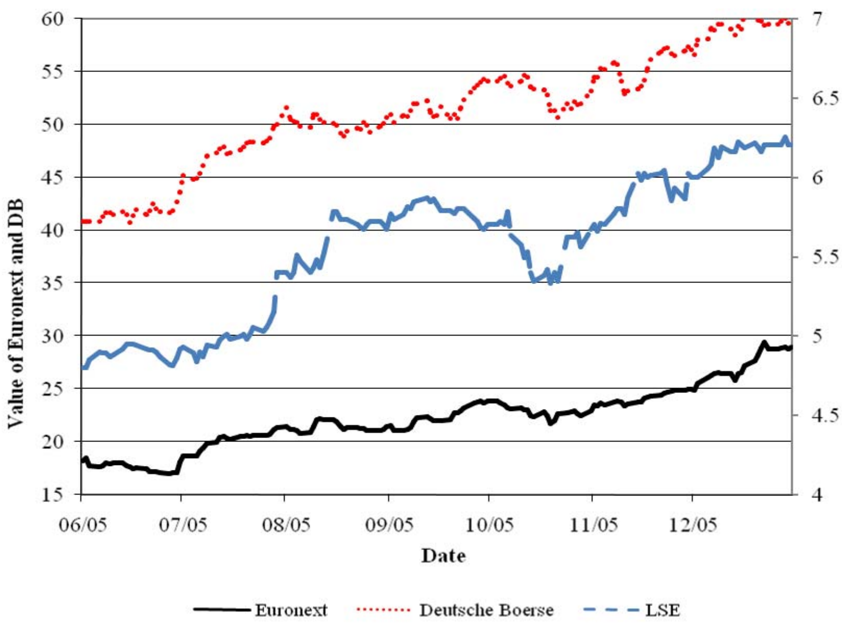
had the support of the majority of shareholders of DB. However, again this claim is suspect given its unwillingness to offer the shareholders a chance to vote on the merger proposal.

TCI later announced that it would use its stake in Euronext to challenge any bid that the Franco Dutch exchange decided to make for the LSE.

D. Life after LSE

Upon successful completion of an activist campaign, many funds, especially hedge funds, divest their shareholdings in order to seek alternative investment opportunities elsewhere.. However, the hedge funds continued to hold their stakes in DB and Euronext, possibly suspicious that a further acquisition attempt might be launched once time had passed. However, Euronext didn't follow up the preliminary proposal it submitted to LSE in January 2005, and Deutsche Boerse made no efforts to resurrect the merger plans.

Figure 1 - Share prices over six months following the takeover battle



The above figure indicates the volatility of the LSE share price as the company attracted the attention of a number of suitors in the aftermath of the failed takeover attempts. The subsequent suitors are outlined below.

In late 2005, the LSE received an offer from the Australian bank Macquarie. However, the 580p a share offer was rejected as derisory by the LSE board. Macquarie eventually dropped its acquisition attempt after it managed to obtain the backing of only 0.4% of the shareholders in LSE. Fearing further acquisition attempts, the LSE started to seek a white knight that it could potentially merge with and safeguard its future. The most likely candidate was thought to be ICAP. However, in February 2006, LSE received an unexpected £2.4bn offer from NASDAQ. Talks continued with Euronext, which itself was in talks with a US exchange (later revealed as NYSE which made a $10bn bid for Euronext) and Deutsche Boerse.

Deutsche Boerse feared being left as a small player in a global exchange industry and outlined its intention to attempt a merger with Euronext. Given the strong opposition it faced only 12 months previously when it attempted to purchase the London Stock Exchange, this was a brave move. Many of the activist shareholders responsible for the coup still held substantial equity holdings. However, in an unexpected move, TCI spoke out in favour of the bid. It expressed the opinion that a merger given the mounting interest of the larger American Exchanges was the only was to guarantee long term survival. The plan was backed by other activists including Atticus Capital and Harris Associates.

At the time of writing, Euronext has agreed in principle to merge with NYSE, although it is still in discussions with Deutsche Boerse. The LSE is still seeking a white knight to protect it from NASDAQ which has built up a 25% stake in the London exchange. The LSE rejected a second takeover offer from NASDAQ on 20th November 2005 as the LSE believes it undervalues its ‘outstanding growth opportunities’.

V. Conclusions

The collapse of the takeover bid for LSE and the subsequent resignation of two high profile board members can bee seen as a major coup for governance activism by hedge funds and mainstream institutional investors. It is remarkable enough that the activists were led by such a small investor as TCI. But it is even more impressive given that the governance regime in Germany very much protects the boards of companies in issues such as takeovers. The effectiveness of the shareholder revolt was a surprise for many commentators as shareholders traditionally had little impact on strategic decisions of this kind at German companies. *"It definitely came as a surprise that the critical shareholders so clearly prevailed,"*[15] says Herbert Bayer, a member of the German exchange's supervisory board.

Initially, the shareholders simply wanted to prevent a strategy that they believed was not the most effective route to create value. However, the full scale war that erupted became much more important – the enhancement of long term performance by removal of a poor governance structure.

The intervention also has wider implications for takeover decisions across Europe. Until recently, most shareholder activism was performed within the boundaries of the United States where activists have been operating widely for the past twenty five years. Takeover defences in the form of poison pills have been widely researched and in this area activists seem to have a large degree of success. However, the shift in focus of Anglo Saxon activists to focus on targets in continental Europe marks a turning point in governance regimes there. Hedge funds are a potential solution to the problems that arise with firm management due to a lack of adequate monitoring by the shareholders. They do not face the same regulatory and legal restrictions suffered by mutual funds, which gives them scope to undertake unorthodox investment practices.

The Deutsche Boerse example also illustrates that a small issue can rapidly escalate into a much more serious problem. Had the Boerse management listened to the investors concerns, they might still have been able to pursue the takeover in a structured manner that the shareholders supported. However, their inability to compromise or communicate with their shareholders was ultimately the cause of the bid's failure. Poor governance at the company allowed the CEO to pursue his own

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[15] "A Little Fund With Big Demands", Business Week, 23rd May 2005

agenda to the detriment of the firm's owners' interests. Ultimately, Seifert and Breuer paid the price for their own mistakes, bordering on hubris.

The corporate control market is advocated as a solution to corporate governance problems as underperforming management structures can be improved by threat of a takeover. However, the market does little to improve governance if the standards are poor at the potential acquirer rather than the target. Activism is a potentially stronger weapon as it requires a much smaller financial outlay. TCI won the battle for Deutsche Boerse with a shareholding of less than 10%. A corporate control solution would have required many times that level to succeed. This case has highlighted the powerful results that can be obtained when equally aggrieved shareholders form a coalition to lobby management. Activism also has tangible benefits in terms of enhanced return. A corporate control transfer can still destroy value despite improving governance if the target is the wrong strategic fit.

Thus, the case of Deutsche Boerse indicates that even small activists can take on a large target in a country where the governance regime stacks the odds against it and still obtain the desired outcome. It marked the turning point for institutional investors and showed that they no longer have to suffer quietly the underperformance of their investee companies.

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