February 23, 2011

Analysis: LSEG-TMX Merger Likely To Hit Regulatory Roadblocks

On February 9, the London Stock Exchange Group and TMX Group announced plans to merge, with LSEG shareholders set to own 55% of the combined entity. The merger will be subject to customary reviews and approvals, including a 45-day review (with a 30-day extension option) by the Canadian government to determine the "net benefit to Canada." As the market is currently giving the deal only a 60% chance of being consummated, we are not the only party questioning its feasibility. In an attempt to handicap the review process, we discuss below the six factors under Section 20 of the Investment Canada Act that will be considered by Industry Minister Tony Clement:

20(a) The effect of the investment on the level and nature of economic activity in Canada, including, without limiting the generality of the foregoing, the effect on employment, on resource processing, on the utilization of parts, components and services produced in Canada and on exports from Canada.

TMX Group CEO Tom Kloet has stated that the proposed merger will provide "the ability for us to reach investors around the world through a larger, stronger group, to present our capital markets via that larger group with touch points in a broader array is good for the capital markets of Canada, it's good for investors that want to invest here, and it makes it more seamless." While the globalization of the capital formation process is clearly well underway, it is also true that many investors continue to have local biases. That being the case, we see the ability for a combined TMX/LSE to promote Canadian issuers to European investors as a benefit to the Canadian economy, albeit one that will likely take years rather than months to realize.

▸ BENEFIT TO CANADA: Positive

20(b) The degree and significance of participation by Canadians in the Canadian business or new Canadian business and in any industry or industries in Canada of which the Canadian business or new Canadian business forms or would form a part.

The joint press release headline characterized this as a "merger of equals," with Kloet speaking first on the conference call and French being spoken by both parties. To us, however, this appeared to be nothing more than a transparent attempt to pre-emptively curry favor with Canadian officials who, late last year, rejected BHP Billiton's proposed takeover of Potash Corp. The fact is, while presented as one, this is not a merger of equals. The combined entity would have a majority of its shareholders (55%) and board members (8 of 15), as well as its CEO (Xavier Rolet), come from the LSE. Furthermore, the market capitalization of companies listed on the London exchange is 1.7x greater than that of those on the TSX.

If the current trend in exchange consolidation continues, this will likely not be the last deal made by LSEG. And with the addition of new entities – with different economic interests, cultural nuances and regulatory requirements – Canada's importance will almost certainly wane, regardless of what businesses the combined entity bases in Canada post-close. While the BHP/Potash deal is clearly different in many ways, it should be noted that BHP made a number of significant commitments in regards to Canadian employment, going so far as agreeing to a performance bond to ensure fulfillment of the contract. This was not enough for the Canadian government to approve, however.

- BENEFIT TO CANADA: Negative

20(c) The effect of the investment on productivity, industrial efficiency, technological development, product innovation and product variety in Canada;

The combined group will likely provide the ability to trade some new financial products in Canada, while allowing the TMX to combine its technology development and maintenance efforts with those of another large player. These impacts will be quite specific, however, and should not have a significant impact on the overall Canadian economy.

- BENEFIT TO CANADA: Neutral

20(d) The effect of the investment on competition within any industry or industries in Canada.

It is possible that competition in the Canadian trading venue space will be enhanced due to new technological and product development capabilities of the combined entity, though this would likely not materialize for several years, providing the incumbent players in Canada ample time to innovate and upgrade. The trading venue "industry" in Canada is currently not large in terms of revenue or employment, nor does it figure to be in the short to medium term.

Additionally, Canadian issuers, more so than today, will compete for capital at a regional and global level, with investment returns being determined by the efficacy of this capital usage. All industries – but in particular, the resource-based industries – should see increased competition.

- BENEFIT TO CANADA: Slightly Positive

20(e) The compatibility of the investment with national industrial, economic and cultural policies, taking into consideration industrial, economic and cultural policy objectives enunciated by the government or legislature of any province likely to be significantly affected by the investment; and

Generally speaking, Canadian policy seeks to ensure Canada's "ownership" of its culture. As the Toronto and Montreal Exchanges are important at both strategic and symbolic levels, we do not believe that the government will feel comfortable ceding control of either. While least concrete, this factor may ultimately prove to be one of the most important determinants in Minister Clement's decision.

▸ BENEFIT TO CANADA: Negative

20(f) The contribution of the investment to Canada's ability to compete in world markets.

If this merger is not approved, some will argue that the TMX will be left behind as other global exchange operators consolidate and, as a result, reduce their cost bases and increase their growth potential. But in our opinion, this argument is unlikely to sway Minister Clement. In 1998, the Canadian Imperial Bank of Commerce and Toronto Dominion Bank announced merger intentions, followed shortly thereafter by the Royal Bank of Canada and the Bank of Montreal doing the same. All parties argued that to compete globally, they had to increase in size. However, both mergers were blocked for failing to comply with the Investment Canada Act, with the government citing, among other reasons, a reduction in its flexibility to address future concerns.

More than ten years later, it is clear that the banks' arguments were not borne out. Canadian banks have not been left behind; on the contrary, they have remained solvent, profitable and globally relevant through a devastating financial crisis. Had mergers with foreign banks occurred, it's entirely possible that Canadian banks would not have been as sheltered as they were. With the Canadian government's commitment to ensuring that the best interests of Canadians are protected, it is easy to see how Minister Clement might find that being "left behind" isn't always a bad thing.

That said, the counterpoint to this argument is that the merger could provide Canadian issuers with better opportunity to compete through increased access to global capital.

▸ BENEFIT TO CANADA: Slightly Negative

Additional Factors that Will be Considered

Provincial Regulators: Minister Clement has stated that he will work closely with the Provinces, as securities regulators in Quebec, Ontario, Alberta and British Columbia have the ability to perform their own reviews. In addition, the Ontario Securities Commission must approve, under Section 21 of the Ontario Securities Act, any acquisition of more than 10% of any issuer on the Toronto Stock Exchange. While Ontario's finance minister has commented about the need to protect "strategic assets," the provincial regulators themselves have given no indication as to their leanings.

▸ IMPACT ON CHANCES OF DEAL CLOSING: Neutral

Chartered Banks: There are a number of reasons why the Canadian chartered banks (BMO, CIBC, National, RBC, Scotia and TD), some of whom have been denied merger opportunities based on similar arguments, may not favor the merger. Traditionally, they have owned and/or controlled much of the TMX's operations, and this combination would remove a considerable portion of their influence on Canadian capital markets. Second, their investment banking groups would most likely face more competition from global players as Canadian listings get more exposure. Finally, it could reduce their overall clout if the greatest growth potential for the group is seen globally rather than locally, thereby making the opinions of the TMX's biggest customers less influential. That being said, the chartered banks have thus far been positive on the deal publicly.

▸ IMPACT ON CHANCES OF DEAL CLOSING: Neutral

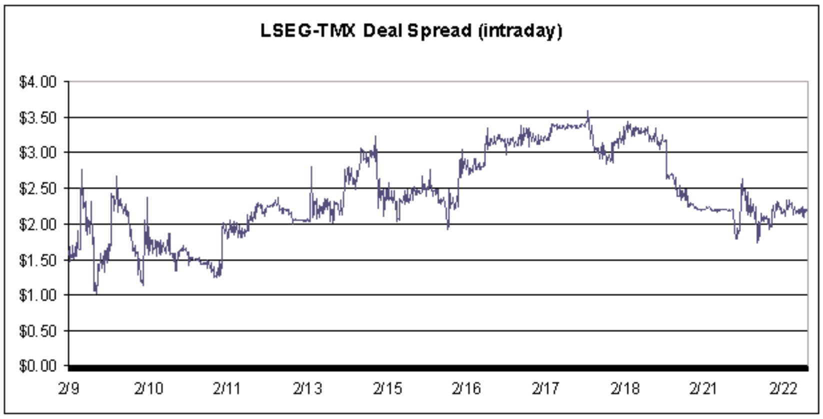
Issuers: Canadian issuers are likely to support this combination since it is likely to increase their ability to obtain capital.

▸ IMPACT ON CHANCES OF DEAL CLOSING: Positive

Public Sentiment: Much of the Canadian public is asking, "What does this mean for me?". The answer, unless investment in Canada increases in a dramatic way, is likely "not much," at least in the short to medium term. That being the case, most Canadians seem unwilling to give up control of their national exchanges. With a national election potentially on the horizon, and neither party currently polling particularly well, there will likely be little political appetite by either party to go against popular opinion.

▸ IMPACT ON CHANCES OF DEAL CLOSING: Moderately Negative

The Market: Looking at implied annual returns for the entire universe of deals currently outstanding, most imply spreads (i.e., the annualized difference between the deal price and the current market price) of 5-8%; this deal is offering a return of three times that, assuming a six month closing time. While the NYSE Euronext-Deutsche Boerse deal is trading through the deal price, with many attributing this to speculation of a competing bid from the CME, the market is pricing the LSEG-TMX deal at only a 60% chance of completion according to the spread.



Source: Bloomberg

Conclusion

Based on the factors outlined above, we do not believe that the proposed merger, as currently constituted, will make it through the Canadian regulatory process.

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