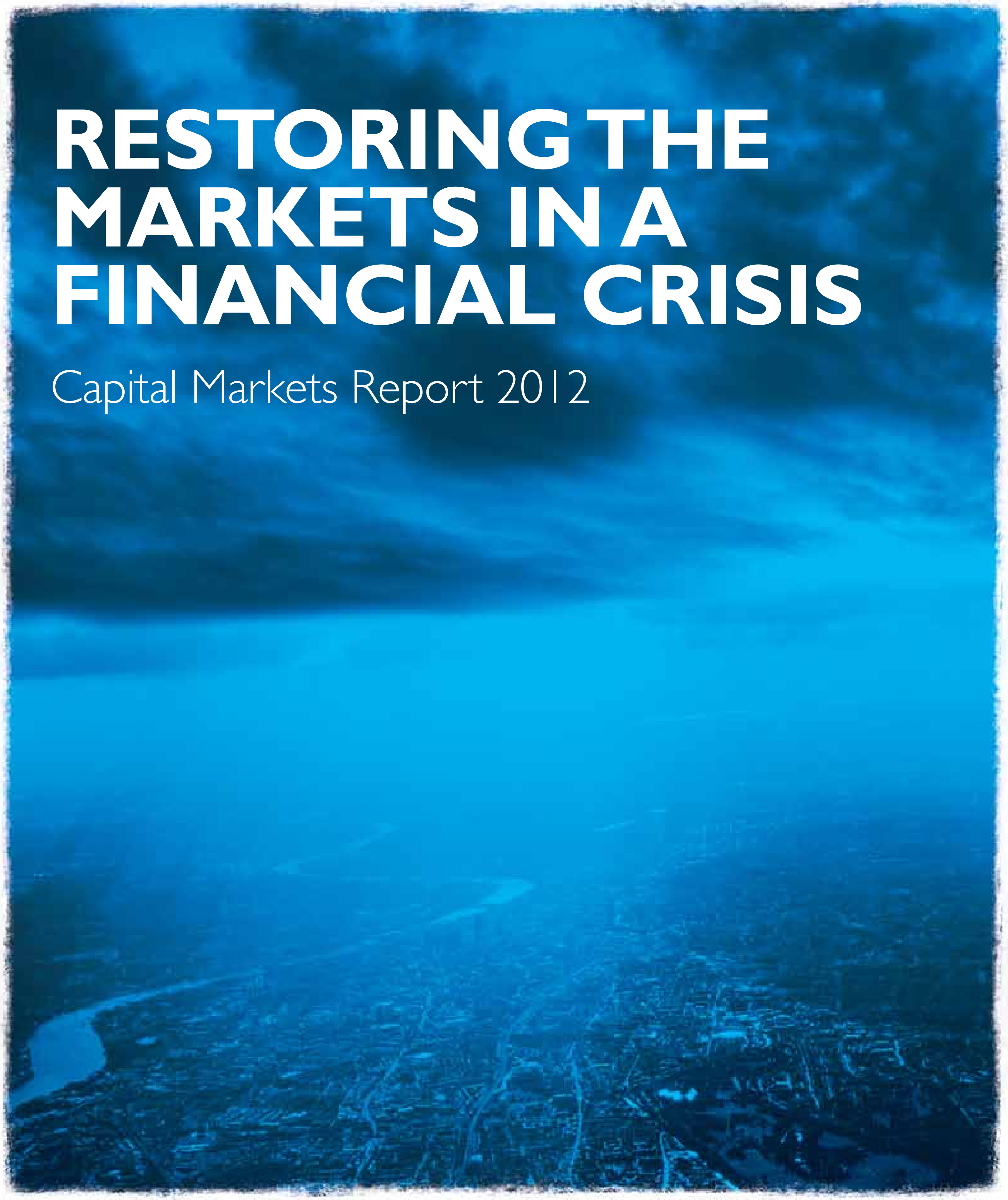
RESTORING THE MARKETS IN A FINANCIAL CRISIS

Capital Markets Report 2012



DLA PIPER

HANSON GREEN

CONTENTS

OUR ADVISORY COMMITTEE

The focus of our report, and the questionnaire which we used to gather information from respondents, was developed in conjunction with a special committee of advisors. We should like to take this opportunity to thank each of the committee members for giving generously of their time to this project and for the valuable insights which they provided in refining the focus of both our investigation and of this report. The members of the advisory committee are as follows:

James Agnew, Chairman of UK Corporate Broking, **Deutsche Bank**

Andy Brough, Co-Head of Pan European Small and Mid Cap Team, **Schroders**

Mark Hughes, Partner, **PricewaterhouseCoopers**

David Snell, Partner, **PricewaterhouseCoopers**

Tracey Pierce, Director of Equity Primary Markets, **London Stock Exchange**

We should also stress that the opinions, conclusions and recommendations set out in the report are those of DLA Piper alone, and do not necessarily reflect the views either of the members of the advisory committee, Hanson Green or of the Directorbank Group.

INTRODUCTION

The IPO environment in 2010 appeared encouraging – a market in recovery following the credit crisis of 2008 and 2009 and, according to contemporary research, a year in which global IPO fundraising reached its second highest level ever. The potential risks and uncertainty in the macro economy were duly noted but it was envisaged that, barring another unforeseen crisis, global IPO markets could potentially be at least as dynamic in 2011 as had been the case in 2010.

During the course of 2011, however, these macroeconomic risks have become a reality. The spectre of a double-dip recession hangs over many national economies, not least the UK, with the sovereign debt crisis weighing on the prospects for economic growth in Europe and beyond. A further phase of the credit crunch appears to be unfolding, with the Eurozone in conflict and a number of European banks reported to be under severe financial pressure.

At the time of writing, it is by no means clear how long the current period of economic and financial uncertainty will last or indeed how pronounced any further decline might be.

In 2008, DLA Piper commissioned an international programme of research into capital markets that sought to explore a number of key trends, challenges and emerging priorities from the perspective of senior decision-makers in leading companies, as well as the investment banks which advise on debt and equity strategies. We explored how the capital markets landscape appeared to be changing; highlighted how the credit crisis might influence funding techniques; and set out the need for corporate governance frameworks to add more tangible value to businesses.

Since that report, the uncertain economic, business and financial climate has drawn into sharp relief a number of other significant issues which have dogged the capital markets for some time – issues such as the availability of finance, the efficacy of the IPO model, and the appropriateness of both the regulatory regime and the corporate governance architecture for quoted companies. We now see a capital markets landscape in the UK that is characterised by difficult issues, challenging conditions and less than obvious solutions.

Given this backdrop, we have conducted a further analysis of the capital markets, this time focused on the UK and seeking to address some of the specific issues and challenges we regularly hear about in the course of our work with clients, as well as in our discussions with other professional advisors.

The primary aims of our current programme are to:

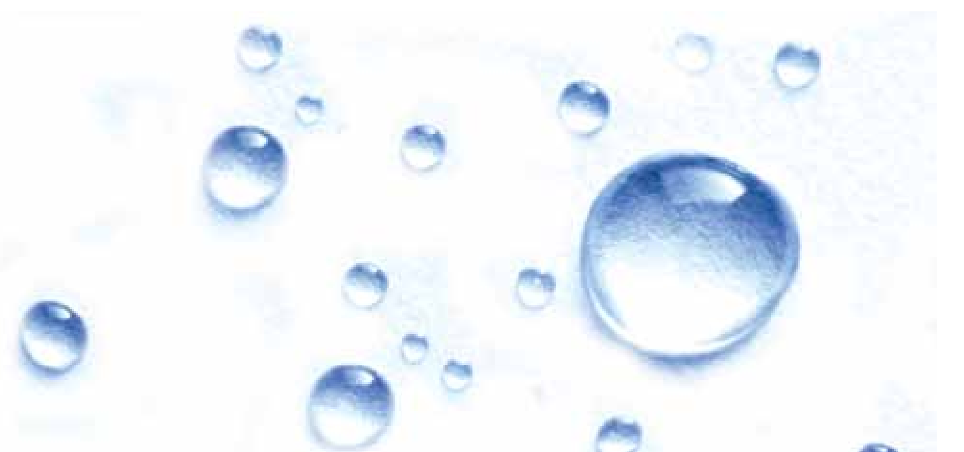
- Develop an understanding of the extent to which UK corporates are seeking to enhance the diversity and sophistication of their funding and investment strategies.
- Investigate what is really at the heart of the issues that have caused the IPO model to become compromised and what can be done to improve it.
- Highlight how the corporate and advisory community feels about the current state, and future, of capital markets in the UK.
- Identify those features of corporate governance which are seen as adding demonstrable value to businesses, and those where the benefit is more apparent than real.

Our report, which is based on contributions made by over one hundred senior corporate decision-makers and professional advisors, highlights the key issues for consideration and implementation by potential entrants to the markets, existing issuers and market participants. It provides a stark assessment of the challenges ahead and the priorities that need to be addressed if the UK capital markets, and the various elements of the regulatory environment which underpin them, are to function effectively in the future. In some areas, the potential solutions are neither easy nor quick to implement. However the feedback received from our contributors is sufficiently clear to flag the imperative for action, and to particularise some of the steps which need to be taken.

We hope that you find of interest and value the key insights contained within our report, as well as the conclusions and recommendations which we have drawn. We should very much like to thank all those who took time to make a contribution. If you have any comments or questions after reading the report, we would be delighted to hear from you.

Alex Tamlyn
Head of EMEA International Securities Group
DLA Piper UK LLP

March 2012



EXECUTIVE SUMMARY

The feedback received from our contributors has been generous and wide-ranging and there are a number of important and interconnected themes which emerge. The following, in particular, appear to us to be fundamental to an effective restoration of market function.

The benefits of a truly diversified pattern of funding will only be possible if there is an improvement in the corporate sector's awareness and understanding of the range of fundraising options at its disposal

Many companies see genuine benefit in maintaining a multi-faceted structure to the financing of their businesses. Nevertheless, the fundraising market is still characterised by a degree of imperfect information. Awareness of flexible and cost effective private placement products, for example, is relatively low in comparison with alternative financing routes.

The current IPO model will not be 'fit for purpose' until there is a more cooperative partnership between the participants at the centre of the process

Present concerns about market inertia in the UK have much to do with the perceived effectiveness of the IPO model itself, with the IPO being seen as the basic building block of market functionality, both in terms of profile for the markets themselves and as an assurance of quality of the issuers on the markets over the long term. The concerns focus most particularly on the way in which prices are set, the approach to bookbuilding and the quality of the relationships that exist between the stakeholders involved in the successful completion of an IPO. There are areas in which the processes and techniques which have developed over time have not necessarily represented an improvement over their predecessors. In some cases at least, "original" might also have been "best".

The current 'trust deficit' within the commercial environment at large is an intangible yet highly potent factor contributing to market disharmony. It may create an opportunity for 'advisory only' houses to play an expanded role, particularly if they succeed in providing a more tangible demonstration of their value proposition

Depending on the circumstances of the issuer and the specific structure of the offering, 'advisory only' institutions may have a valuable role to play within the capital markets arena. If the apparent 'trust deficit' within the business environment persists, it is conceivable that corporate decision-makers will increasingly consider turning to advisory only houses to provide the genuine level of independent thinking and objectivity of guidance which they currently seek from their professional service providers.

The financial regulatory regime may continue to fail to deliver optimally, unless it achieves a more effective balance between a 'top down' and 'bottom up' approach

The regulatory regime in the UK is no longer acknowledged to be 'state of the art'. This might be, in part, an issue of communication and the level of understanding of the regulatory approach. However, a key reason why the regime has not delivered as effectively as commentators and stakeholders would expect of it, may be due to its emphasis to date on a 'top down' approach, focused on the size, status and capital structure of institutions. There has been a perceived comparative lack of focus on a 'bottom up' approach which seeks to foster and optimise the interactive behaviour between individual market participants.

The London markets have a viable future, regardless of whether the London Stock Exchange completes a merger. The London Stock Exchange brand is in many ways a mirror which reflects the conduct of market stakeholders. Those stakeholders must acknowledge responsibility for enhancing, defending and nurturing that brand and for improving the clarity of communication with key participant groups

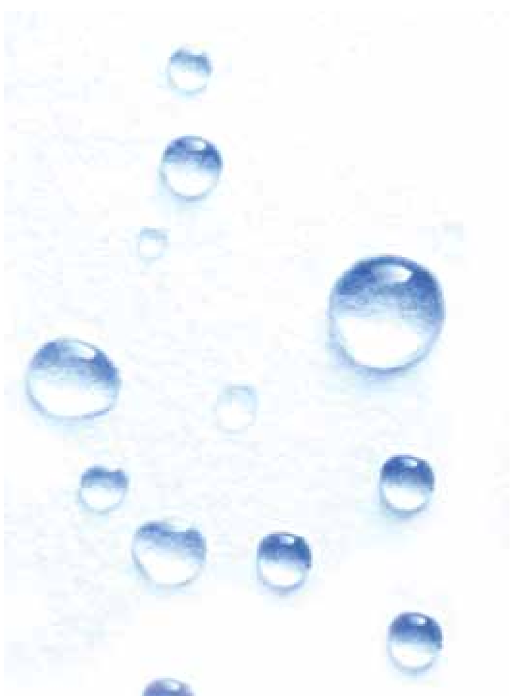
The LSE continues to be essential to the UK financial markets, as well as to the maintenance of London as a key financial centre. However, the London market proposition has been challenged over time by the volume of new entrants being prioritised at the expense of an appropriate level of control on the quality of those companies. Responsibility for maintaining the quality proposition is collective. It lies principally in the hands of the market participants, including the advisory community. The brand of the London markets in general, and of the LSE in particular, is to a large extent reflective of the degree to which that responsibility has been discharged.

Optimising the corporate governance framework requires a greater focus on the relationship between board composition and value enhancement. For an effective board, merely re-balancing the risk/reward equation for directors will not in itself be sufficient

Executive directors, non-executives and advisors alike are increasingly recognising the beneficial impact that intelligent and relevant corporate governance can have on the perceived quality of a business. With that in mind, it has become fashionable to focus on the balance between risk and reward for directors, particularly non-executives where what was historically seen as a 'lite' route to board participation is now understood to require fuller attention and focus from those involved, together with a greater commitment of time. Although that is clearly relevant in attracting talent, our respondents indicate that the key factors determining the quality of corporate governance relate primarily to board composition. There is strong demand for board composition to be focused on generating tangible value and not just delivering diversity for diversity's sake.

A NOTE ABOUT PRESENTATION OF SOME OF THE DATA

As part of the study, our contributors were asked to respond to a series of statements, reflecting topical issues and potential concerns, by indicating whether they 'strongly agreed', 'agreed somewhat', 'disagreed somewhat', 'strongly disagreed' with the sentiment expressed or indeed were 'neutral'. In practice, there are a number of ways in which the results from such questions can be presented, but we have chosen to show the 'net balance' of respondents. This is calculated by adding together those respondents that agreed (either strongly or somewhat) and then subtracting those respondents that disagreed (strongly and somewhat). The resulting figure is then expressed as a percentage of those respondents who were willing and able to comment on the statement in question. (Note: in the charts we have used the shorthand version '% who agree with the statement less % who disagree'.)



A DIVERSE LANDSCAPE

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Given the challenging market conditions of the last few years, it is not surprising that the majority of companies contributing to our report indicated that they had either contemplated, or been involved in, the raising of finance at some point during the period. Although the stated purpose of raising funds was often 'defensive' - seeking working capital to shore up and strengthen the balance sheet - frequently there was another motivation at play. Indeed, one in every three organisations, and most especially those in the smaller company segment of our sample, indicated that they had been seeking to raise funds for more opportunistic purposes, such as acquisitions. By contrast, the larger companies in the sample were significantly more focused on refinancing debt and other funding programmes that were already in place.

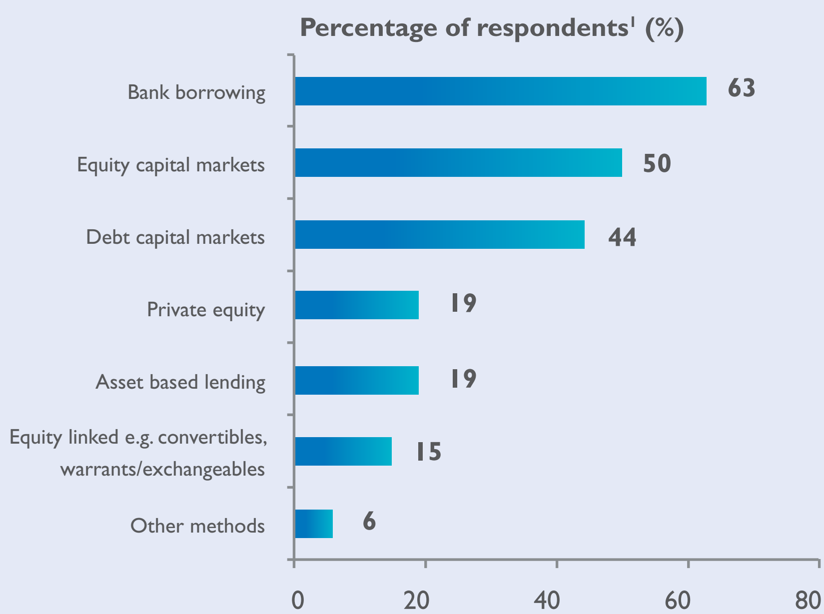
In our 2008 report we suggested that, as well as presenting clear challenges for issuers it was conceivable that the financial crisis unfolding at the time might, in the longer-term at least, act as a catalyst for the development of more creative funding techniques. We also noted that it might encourage companies to seek a greater diversity of financing, rather than relying solely on their relationship bank lenders.

"The fundraising market is still characterised by a degree of imperfect information."

The feedback received from our 2011 contributors indicates that many companies see genuine benefit in maintaining a multi-faceted approach to the financing of their business. Nevertheless, it also suggests that there is a desire for even greater diversity in the future. As Chart 1 shows, in their search for funding, many UK companies considered not only borrowing from their relationship banks but also raising finance through the equity or debt capital markets. The majority of companies indicate that they have considered more than one financing avenue. Their feedback however suggests that asset based lending, as well as the use of equity-linked products such as convertibles, are considered far less frequently than other routes.

As one might expect, within this overall picture there are some notable variations in approach between companies of different sizes. It is apparent, for example, that consideration of the debt capital markets increases significantly with company size and that the larger companies were also a little more likely to have considered public equity fundraising. By contrast, the smaller companies were more likely to have contemplated the injection of funds from private equity.

Chart 1: Fundraising methods considered by UK companies



Note: [1] Percentage of respondents that have contemplated or been involved in the raising of finance in 2009, 2010 or 2011

Taken as a whole, the feedback suggests that diversity of funding is still relatively uneven within the UK market. But, in reality, how important is it that corporate financing makes use of a wide variety of techniques, and how close is the current position to what might be considered ideal? On the face of it, and in theory, there are a number of potential benefits from a properly diversified pattern of funding, such as a more efficient allocation of capital as well as greater certainty of obtaining finance - both of which have consequential benefits in bringing forward investment and corporate development planning. Moreover, for professional advisors, there is a clear benefit in being better placed to identify and implement an effective solution for a client's financing needs.

In practice, a greater diversity of funding will only come about if the markets are open to such developments and adapt to accommodate such funding. Adaptation in this context appears to have several components: (i) Availability (individual avenues remaining open to prospective issuers); (ii) Awareness (those who seek funding being enlightened about the full range of methods available to them); and (iii) Alignment (the perceptions that corporate decision-makers hold of individual techniques being at least broadly in line with 'reality', especially in terms of cost and timing). Each component will be affected not just by size but also by industry sectors and geographies. Our contributors' feedback suggests that the fundraising market is still characterised by a degree of imperfect information.

One of the clearest examples of the communication gap that exists can be seen in relation to MTN programmes, for which awareness is relatively low in comparison with alternative financing routes. Not surprisingly, the lack of awareness of MTN programmes appears most pronounced amongst unquoted companies. Although conceived originally as a funding tool for highly rated credits with a presence in the capital markets, nevertheless, it is not exclusively an issue of company status. The MTN platform lends itself to bespoke issuance and niche placement, at low cost, for a given number of deals. Neither is it one of company size: indeed, a number of our contributors from quoted mid market companies indicated that they were unaware of MTN programmes as a funding method.

The feedback also suggests there are widespread perceptions about the unsuitability of a broad range of potential financing options, including corporate bonds, securitisation and asset based lending. These perceptions may of course be based on the genuine analysis, and in some cases the direct experience, of our contributors.

DLA PIPER VIEWPOINT

"MTNs could have a role as one of the options for corporate funding in a lean market for bank debt. Just as Eurobond issuers came to embrace that particular method as a cost saving tool in the 1990s, until standalone bonds became the exception rather than the rule today, so UK companies who have not issued bonds before will look at the MTN product to raise funds directly from investors on a regular basis, both for public deals and for smaller private placements."

David Eatough
Partner, International Securities Group
DLA Piper UK LLP

However, just as with low awareness of MTN programmes, they may also reflect a lack of knowledge within the target market.

How will the communication gap that appears to exist be bridged? Although companies themselves need to do more to ensure they are in a position to explore the merits of alternative approaches, it also seems fair to suggest that there is a role here for professional advisors as well. In recent years some UK focused advisory firms have made significant investment in their ability to offer a full range of funding options to corporate clients, perhaps combining their perception of an unmet need with a healthy reluctance to take as read the

DLA PIPER VIEWPOINT

"Although Asset Based Lending (ABL) remains a mainstream financing technique in the US, it is less well understood in the UK market. It is, however, a sophisticated financing technique which is regularly utilised by large corporates and private equity houses. It is suitable for a variety of industry sectors including manufacturing, retail, telecommunications, recruitment, distribution and energy. Its capital treatment is more efficient than leveraged debt, given the collateral monitoring techniques which it employs. Overall, therefore, as traditional forms of bank lending continue to be scarce, ABL is a relevant, available and cost-effective source of debt which evidently does not yet have the visibility that it deserves."

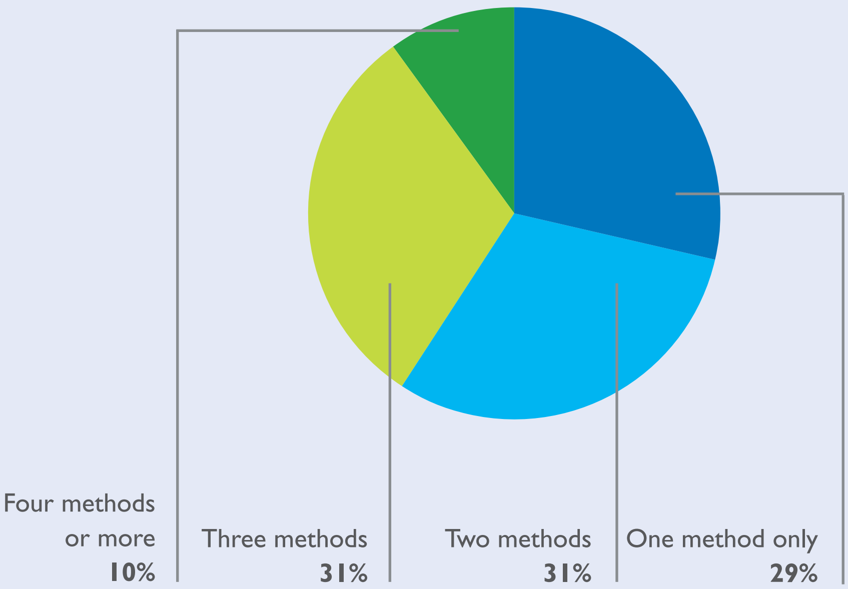
Alex Dell
Partner, Finance and Projects, DLA Piper UK LLP

traditionally limited choice of offerings made available to all but the largest and most multinational of businesses. At the time of writing, however, such firms remain relative pioneers and, by definition, in the minority.

To complete the landscape we took a fresh look at the current perception and utilisation of Private Investment in Public Equity (PIPEs). Once again, our research suggests that (in direct contrast with the US market) PIPEs are not currently a popular funding technique amongst UK quoted companies. Actual awareness of PIPEs in the UK corporate market, at least within large and medium sized organisations, appears reasonably widespread but, like many other financing methods, the model tends to be presumed 'unsuitable' for the circumstances of individual companies. In reality, a handful of UK based advisors (perhaps those with international clients), regarded PIPEs as a popular funding device. However, it appears to be the case that decision-makers in UK companies do not perceive PIPEs to offer any of the benefits of customisation, flexibility and speed of completion that are sometimes suggested to be available in the context of the US market.

Chart 2: Number of fundraising methods considered by corporates

Percentage of respondents[1,2] (%)



Note: [1] Percentage of respondents that have contemplated or been involved in the raising of finance in 2009, 2010 or 2011

[2] Percentage figures do not sum to 100% due to rounding

Detailed analysis of the feedback from corporate decision-makers reveals that when a fundraising exercise is being contemplated, more often than not the company actually considers a number of alternative methods. Although nearly three in 10 companies consider just one fundraising method, just over four in 10 actually consider three or more potential avenues. Looking at these results by size of company suggests that, in practice, there is not an enormous difference between larger, medium sized and smaller companies in the extent to which a range of alternative approaches are considered.

DLA PIPER VIEWPOINT

"PIPEs have always been a challenge for the UK markets, which hold equal treatment of shareholders and non-preferential disclosure of price sensitive information as paramount. This sits uneasily with the private equity investor's desire to occupy a privileged position in relation to an investee business. It is a tension which is likely to persist."

Alex Tamlyn
Head of EMEA International Securities Group
DLA Piper UK LLP

THE NEED FOR PARTNERSHIP

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For 2011, the London Stock Exchange's own statistics[1] reveal that there were a total of 60 new issues on the Main Market. 28 of those were 'introductions', with no capital raising. From the 32 issues involving fundraisings - placings and public offers - which did take place, a total of £11.8 billion was raised. Those figures do not sit particularly well with the comparable figures for 2006, which record 83 placings and public offers with £18.9 billion raised. Indeed, going back 10 years, to 2001, there were more than twice the number of placings and public offers than was the case in 2011.

Fluctuations in statistics like these are inevitably influenced by macroeconomic, business and financing cycles, but it is clear that the 5 and 10 year comparisons lend some support to underlying concerns that have been raised about the present 'inertia' within the IPO market in the UK.

Notably though, the feedback we have received from our contributors suggests that the core challenges are not so much to do with a shortage of issuers in the current market; nor are they a reflection of the resources that investors have at their disposal; nor indeed the relative cost of companies obtaining a listing on the London market. Rather, the concern around the present inertia of the market in the UK has more to do with the perceived effectiveness of the IPO model itself. There are already many column inches asserting that the model is broken, but there has been less of a consensus about how to fix it. Our analysis suggests some of the key building blocks may be found in closer examination of the way in which prices are set, the approach to bookbuilding and, perhaps in particular, the relative level of cooperation that exists between individual stakeholders and participants within the IPO process.

One of the most striking results to emerge from our analysis relates to **price expectations** for new issues. As we demonstrated in our 2008 report, the process of valuing a business for an IPO often poses specific difficulties for corporate decision-makers. However, our contributors very strongly support the premise that prices are set too high and often driven by a requirement on the part of selling shareholders to demonstrate a minimum rate of return on their own investment without sufficient acknowledgement of the true, intrinsic, value of the underlying business. Indeed, while the London Stock Exchange suggests[2] its own data does not support the notion about IPO pricing and valuations being out of line, it does acknowledge that there is a perception issue which needs to be addressed.

Although it is a charge particularly levelled at private equity shareholders, we suspect the concerns around 'optimistic pricing', and of unrealistic vendor expectations more generally, are issues that have a much wider applicability to selling shareholders within the UK market.

Alongside unrealistic expectations, **incentive fees** also cause concern amongst corporate decision-makers.

> **"Incentive fees also cause concern amongst corporate decision-makers."**

Sometimes seen as driving added value, incentive fees appear increasingly to be a feature of engagements within the IPO landscape. However, market participants (advisors included), perceive that where incentive fees are in place, prices often become inflated. Indeed, there is concern that the market is becoming increasingly 'short-termist' and 'sales driven' in nature. Although few may doubt the commitment of advisors to achieving the best immediate result for their clients, it is less clear whether the best short term outcome is always in the longer term interests of either the client or the market as a whole.

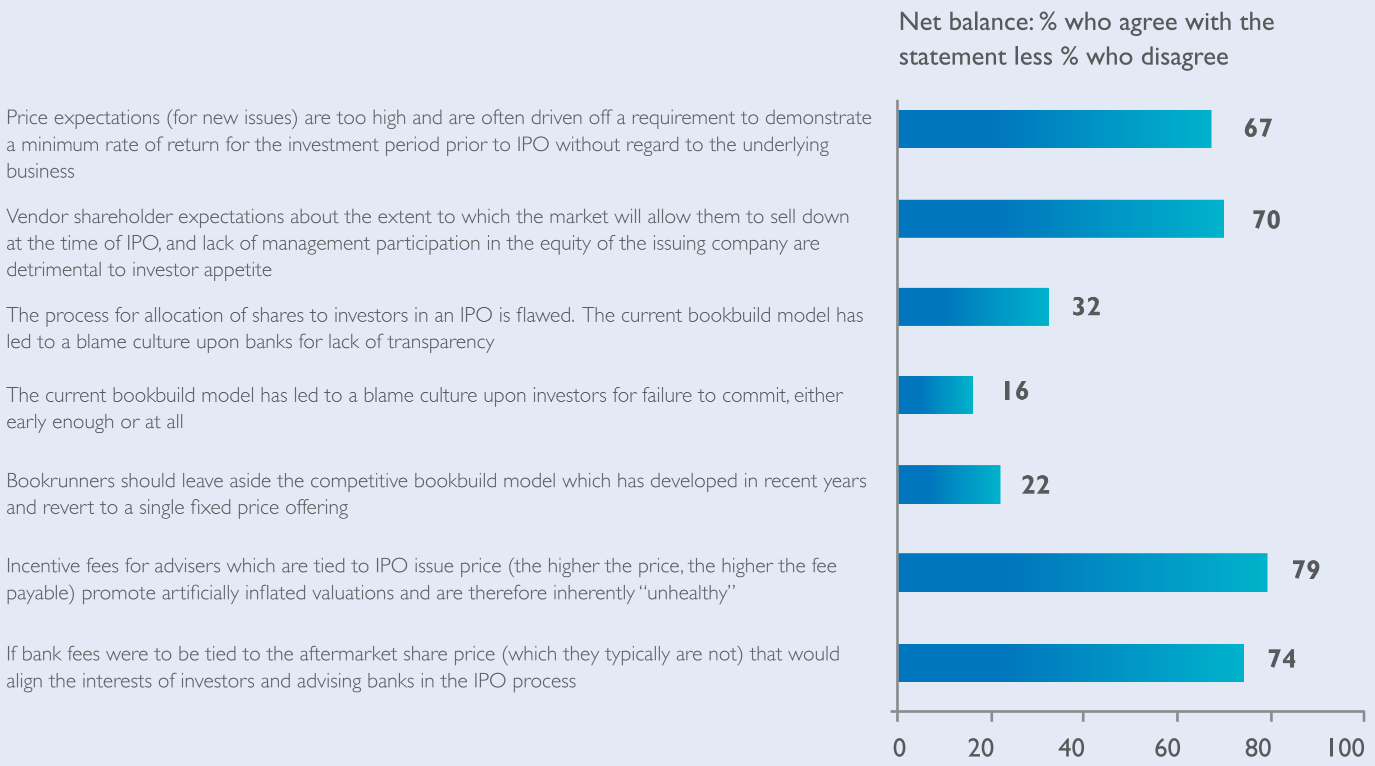
It is likely that these issues are just part of a broader picture suggesting **erosion in the level of partnership** between market participants and, fundamentally, in the level of trust which has traditionally underpinned the operation of the capital markets – a scenario that is also reflected in other recent survey data[3]. An unequal partnership between companies coming to the market and banks bringing them to the market is a feature of the new landscape which our contributors all too readily recognise, and in this respect things are seen to have changed. Indeed, our contributors suggest that the degree of partnership between the players in the IPO process has drifted, slowly, but surely, over time.

[1] Main Market: Market Statistics, December 2011 (as well as December 2001 and December 2006), The London Stock Exchange

[2] "Leadership in a changing global economy: the future of London's IPO market", The London Stock Exchange, 2011

[3] "It's official: the IPO market is broken", Financial News, 4 July 2011

Chart 3: Corporate perceptions of the IPO Model



The breakdown in the partnership approach which has historically supported the IPO market is also reflected in the 'blame culture' that appears to have developed, at least partly, as a result of perceived flaws in the **bookbuilding process**: specifically, a lack of transparency on the part of banks and a failure of investors to commit in a timely fashion during the allocation process. As a result, there is some support for the proposition that the current bookbuilding process should be replaced by a single fixed price offering, although this view is not supported overall by advisors.

Whether or not refinements to some of the processes within the IPO model may be beneficial, there is a fundamental need to rebuild the level of trust and partnership between market participants. We see a number of important reasons why this needs to happen. Without this relationship, underpinned by an appropriate level of trust, it becomes so much more difficult to ensure that issuer expectations on such matters as: timing, pricing, new money capable of being raised, extent of possible sell-down by existing investors, composition of the new investor register and so forth are managed properly; that selling messages are effectively expressed and communicated; and ultimately that the quality of new issues coming to the market is maintained. It is also more difficult to ensure that transparency in the bookbuilding process - not only from the bookrunner's perspective but also in terms of the timing of investor commitment to new issues - is optimised. Indeed, it may be the case that there are areas in which processes and techniques which have developed over time are "merely expedient" and have not necessarily represented an improvement over their predecessors. In some cases at least, "original" might also have been "best".

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A VIEW FROM THE BOARDROOM

"A trusted advisor gives sound advice which is impartial, or which is the right advice, as opposed to necessarily telling you what you want to hear."

Chairman, FTSE 100 company

(Quotation from: 'The Trust Deficit - Views from the Boardroom'. A report by Populus, commissioned by DLA Piper and published in September 2011)

REBUILDING TRUST

The current 'trust deficit' within the commercial environment at large is an intangible yet highly potent contributing factor to market disharmony. It may create an opportunity for 'advisory only' houses to play an expanded role within the IPO model, particularly if they succeed in providing a more tangible demonstration of their value proposition

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Advisory only houses provide advice to corporate and other clients but do not engage in trading activities for their clients or on their own behalf, whether underwriting or otherwise. Consequently, they have very limited direct exposure to the capital markets. They have long been a feature within the capital markets landscape, emphasising their independence and freedom from conflict of interest as a defining quality. Their specific role and contribution to the efficient and effective workings of the IPO model, however, have not always been consistently recognised.

In order to understand the current strength of standing of advisory only houses, and the benefits they are perceived to bring to the corporate finance arena, we put together a number of specific statements for our contributors to evaluate. In particular we wanted to understand how successfully advisory only houses were managing the perceived cost vs. benefit equation, and the extent to which they were seen to have a distinct contribution to make in the transaction process.

"The space that exists for advisory houses within the market landscape may actually be expanding."

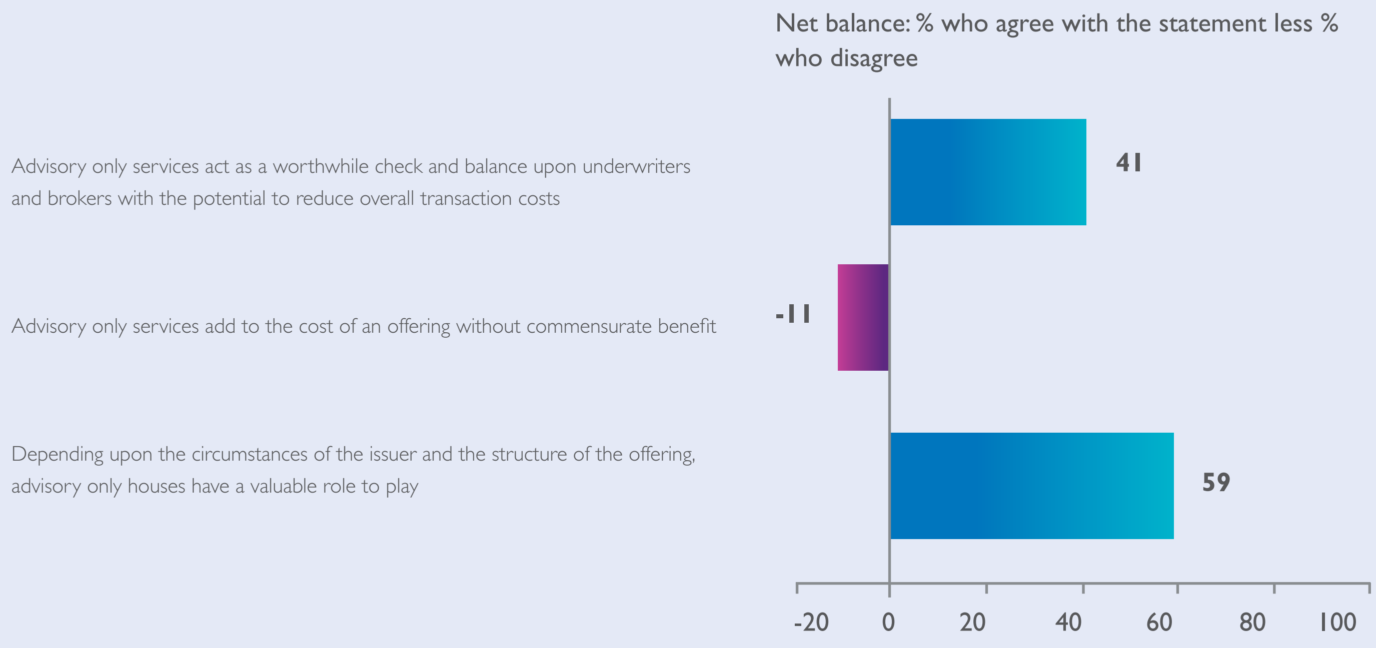
From the feedback received, it is apparent that corporate decision-makers do see a positive role for advisory only services. There is a strong recognition of their potential role in acting as a check and balance on underwriters and brokers, and they are not necessarily seen as simply an added cost for an offering. The response also confirms that, depending on the circumstances of the issuer and the specific structure of the offering, advisory only houses have a valuable impact upon the IPO arena. Indeed, our group of investment banks, brokers and advisors also tended to support the notion that advisory only houses have, in specific circumstances, a valuable role to play.

A VIEW FROM THE BOARDROOM

"It's almost inevitable that if you combine underwriting and trading activity with corporate finance advice, sooner or later you are going to get into areas of balance-sheet related conflict. It leads to confusion over who is actually the client - the corporate, the investor or the bank itself. We want high quality impartial advice which is driven from a concern with our long term interests and isn't tainted by a preoccupation with earnings."

Former CEO, Fortune Global 500 company

Chart 4: Corporate perceptions of 'advisory only' services



Although current moves towards consolidation might at first sight suggest otherwise, it is conceivable that the space that exists for advisory only houses within the market landscape may actually be expanding. If the apparent 'trust deficit' in the capital markets arena continues, it is entirely possible that more corporate decision-makers will consider turning to advisory only houses to provide the independent thinking and objectivity of advice that has always been sought from professional advisors. It may even be the case that some clients are willing to accept a higher level of transaction cost in order to be confident and comfortable they are receiving "the right advice" in the sense that the guidance which they are given is focused solely upon them. There is no doubt that the full-service model is a compelling one and that it is the model which many of the major international investment banks follow. But the combination of advisory, underwriting and trading functions inherent in that model gives rise to fault lines, which are put under considerable pressure in a time of financial crisis. Presently, the evidence suggests that advisory houses will need to improve their ability to demonstrate the potential value they can bring to the process. However, if they can sharpen up their focus in this area, raise their profile and more clearly differentiate their service offering, the environment may be right for them to play an increasing role in the IPO market in the future. There is little doubt that in their current condition and in search of a solution, companies contemplating a fundraising are very ready to hear what they have to say.

A VIEW FROM THE BOARDROOM

"I do not appreciate advisors who have a bias and do not declare it. I want to know why advice is being given. I do not ever want to suspect it's because they will make more money if I follow their advice."

Chairman, FTSE 250 company

(Quotation from: 'The Trust Deficit - Views from the Boardroom'. A report by Populus, commissioned by DLA Piper and published in September 2011)

A VIEW FROM THE ADVISORY COMMUNITY

"Sometimes a Nomad without distribution can work with a broker (that is not a Nomad) to the benefit of a company."

A BETTER BALANCE

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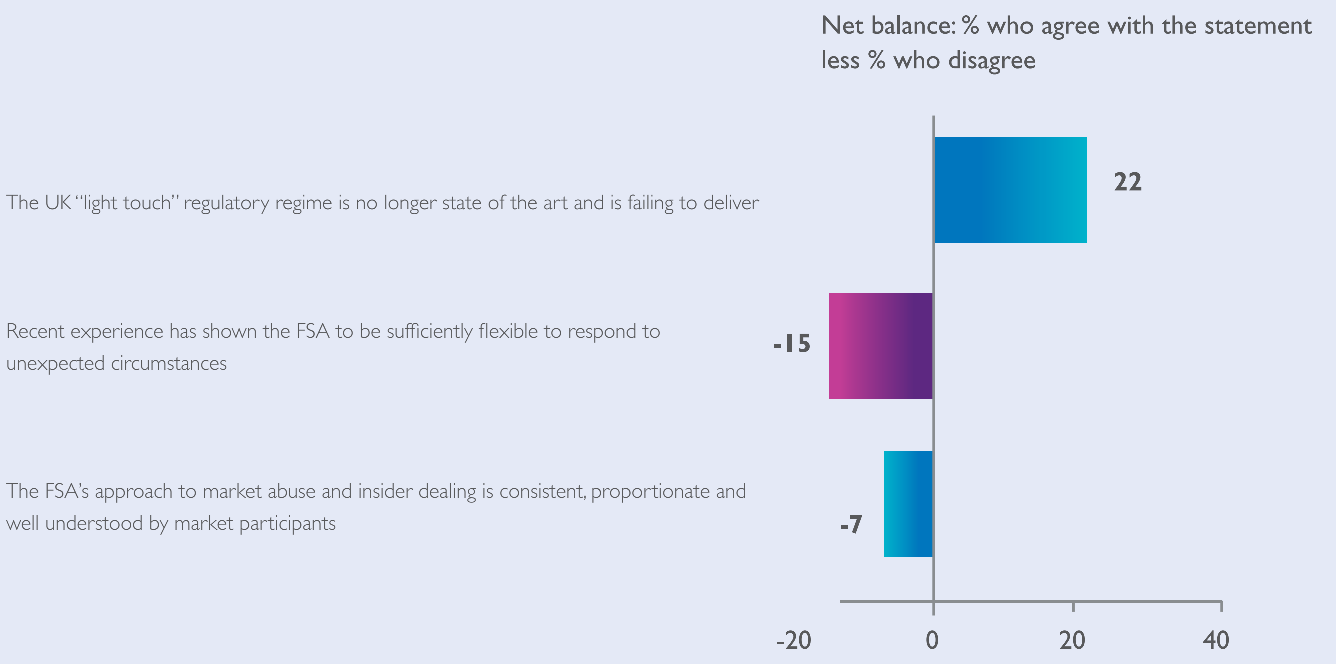
The financial regulatory regime may continue to fail to deliver optimally, unless it achieves a more effective balance between a 'top down' and 'bottom up' approach.

The feedback we have received from corporate decision-makers and advisors paints a stark picture of a regulatory regime in the UK that is no longer acknowledged to be state of the art, and that currently is perceived to lack the key qualities, including flexibility, consistency and proportionality required for it to be truly effective.

> **"There is a perception that regulation is an inadequate substitute for trust."**

Chart 5: Perceptions of the regulation of capital markets in the UK



In practice though, is this a problem of perception or reality? In some respects, it appears to be a communication issue that has much to do with the level of awareness and comprehension that market participants have about the regulatory environment. We see this for example in the mixed responses we received about the FSA's attitude to market abuse and insider dealing, where there are clearly aspects of the approach that are not as well understood as the regulatory authorities would intend.

Similarly, there are also mixed perceptions about the potential implications and effects of the incoming banking regulation[1]. Of course, it is premature for a detailed assessment of the likely impact which this new wave of regulation will have on market participants specifically, and on the capital markets more generally. However, many of those contributing to our report feel that the forthcoming regulation is likely to be excessive. There are also concerns about the indirect effect which this is likely to

[1] e.g. Basel III

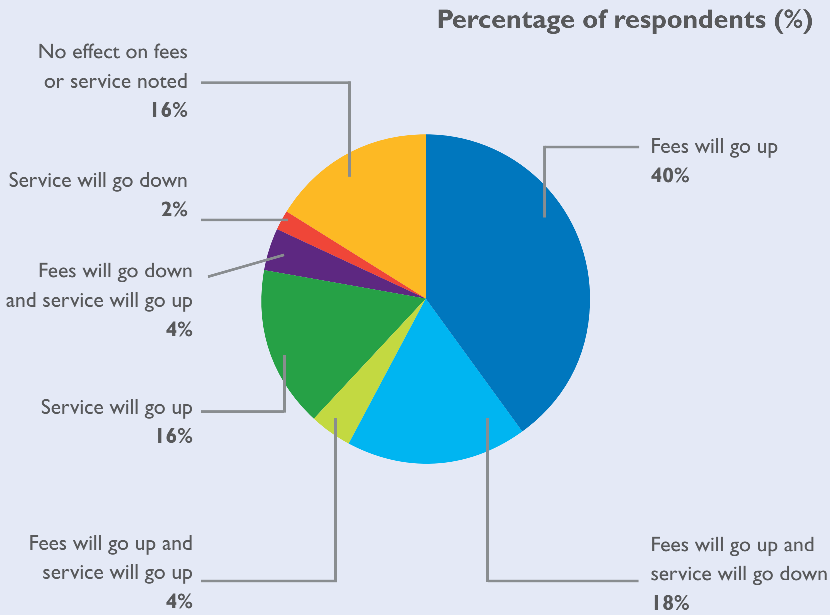
have on participants along the capital markets chain, both in terms of fees and the level of service provided (see Chart 6).

In practice, there may be a number of reasons why the regulatory approach is not seen to have delivered as effectively as market participants would expect of it. One of these reasons may be its emphasis to date on the behaviour of institutions – an approach which has been prescriptive about size, status and capital structure. This 'top down' approach is perceived in some quarters at least as being made at the expense of addressing what happens at an individual level and on the interactive behaviour of individual participants.

Is this important? One reason to think that it is relates to the trust deficit that currently exists within the capital markets arena. Our recent research in this area[2] shows that there is a perception that regulation is an inadequate substitute for trust; and that by specifying a particular set of behaviours, legislation tends to direct organisations towards short term compliance with the letter of the regulation rather than seeking to build more substantive and resilient relationships. Taking all of this into account two key propositions emerge: (i) regulation must pay due regard to the role which individuals have in the proper functioning of the markets and establish a balance between the way that it addresses 'macro' (institutional) and 'micro' (personal) behaviours; and (ii) the 'trust deficit', intangible though it may be, is a real factor in the malaise which currently affects the financial markets and needs to be taken into account in any effective solution. In the context of our report, any solution would require an appropriate level of understanding, transparency and commitment on the part of market participants, as well as a satisfactory measure of objectivity and independence in the advice given. With such a framework in place, it seems more likely that there will be a greater degree of partnership within the financial markets and hence some of the issues currently contributing to a dysfunctional IPO model will become less pronounced.

Of course, a framework based on a more effective partnership between market participants is not something that can be engineered overnight. Moreover, the trust required to underpin genuine partnership within the financial markets cannot be delivered by rules and regulations alone and can only re-emerge through the cumulative effect of a series of small steps. But just because these are not easily achieved, does not mean they shouldn't provide a real focus for attention. Indeed, the weight of opinion suggests that regulation would be more effective if it were specifically constructed to foster and protect a level of partnership that would optimise the operation and efficacy of the markets it is designed to serve.

Chart 6: Corporate perceptions of the potential impact of changes in banking regulation



Contributors were asked whether they thought end investors and other participants in the capital market chain would be affected indirectly through changes in bank regulation, and were able to select whatever combination of fee and service level impacts they felt was likely. The majority took a negative view of the potential effects of the incoming regulation. Four in 10 indicated that they thought fees would go up with no changes in service levels, whilst nearly one in five (18%) thought not only that fees would go up but that service levels would go down as well. Not everyone had such a negative view however. Indeed, around one in six (16%) thought that service levels might improve with no change in fees. Like our corporate contributors, advisors were also negative regarding fees. However, there were rather more mixed views on the potential impact on service levels.

[2] 'The Trust Deficit - Views from the Boardroom'. A report by Populus, commissioned by DLA Piper, September 2011

CLEARER COMMUNICATION

The London markets have a viable future, regardless of whether the London Stock Exchange completes a merger. The London Stock Exchange brand is in many ways a mirror which reflects the conduct of market stakeholders. Those stakeholders must acknowledge responsibility for enhancing, defending and nurturing that brand and for improving the clarity of communication with key participant groups.

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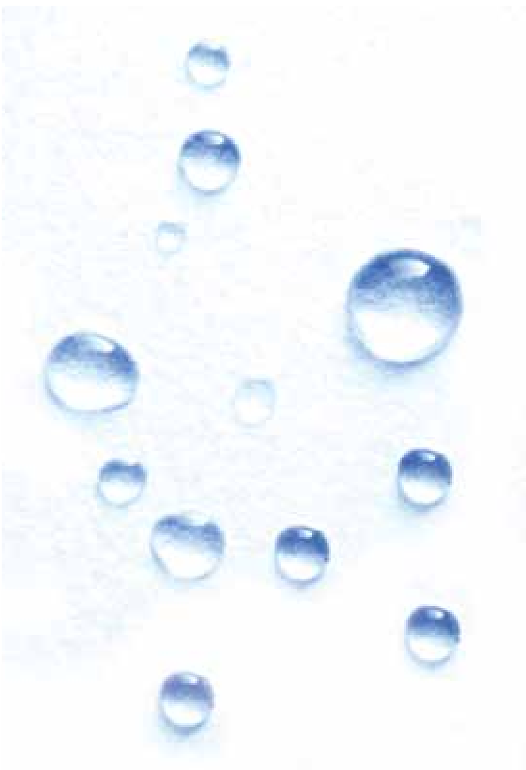
Analysis of international IPO trends[1] shows London held a creditable fourth place in the global league table in 2008, with New York in top spot for capital raised. However, in both 2009 and 2010, it was Hong Kong which led the way, with strong showings from both the Shenzhen SME and Shanghai exchanges.

“It is recognised that the LSE must achieve and maintain a certain critical mass if London is to remain both an attractive and competitive financial centre.”



It is not altogether surprising that London’s relative position as a leading financial centre in a global market is under scrutiny. The recent growth in IPO activity has largely been concentrated in businesses originating from the emerging markets. However this is an era of consolidation and there have been concerns for some time about London’s position on the world stage and its viability as the home of a global exchange without the LSE merging with other players. Although the LSE claims the position as the “world’s most international exchange, with almost 3,000 companies from over 110 countries listed and traded on its markets”[2], monthly statistics about new issues do little to dispel the doubters.

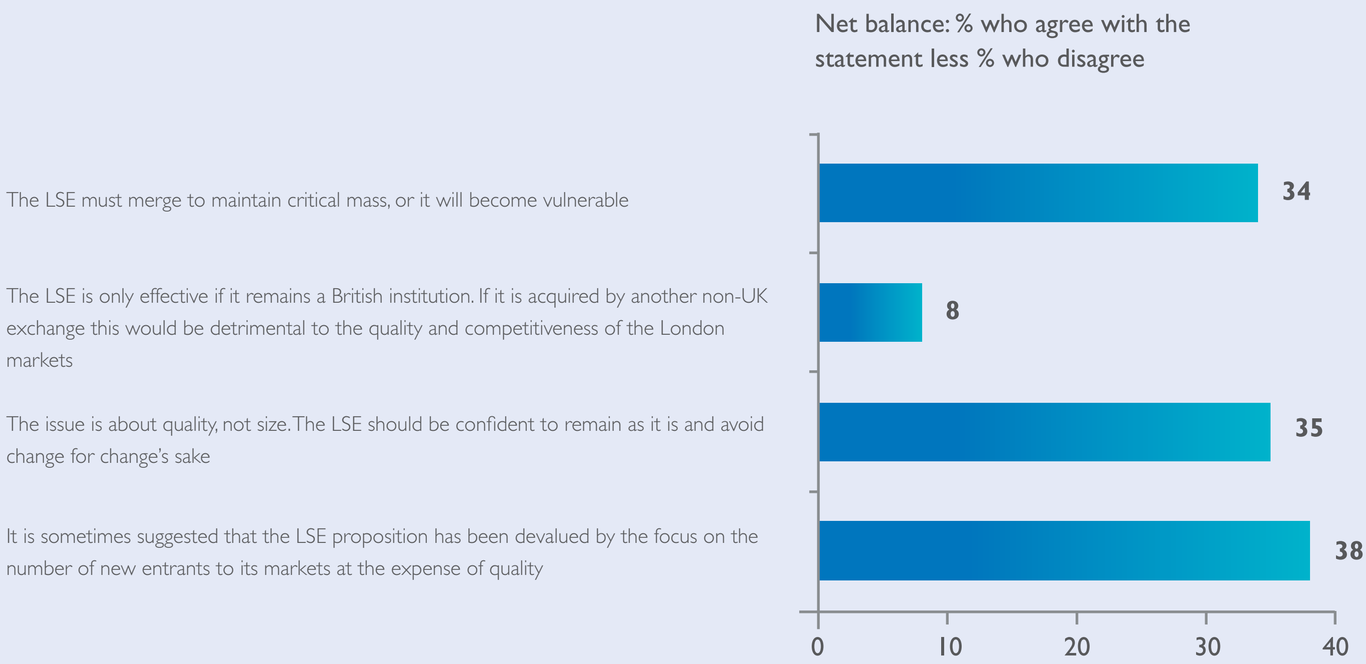
What is clear from the feedback we have received from corporate decision makers and advisors is that the LSE continues to be seen as ‘essential’ to the UK financial markets, as well as to the maintenance of London as a key financial centre. Our contributors were not overly concerned that LSE did not complete a merger with TMX, nor do they see it as overly important that the LSE avoids being taken over by a foreign institution. However, it is recognised that the LSE must achieve and maintain a certain critical mass if London is to remain both an attractive and competitive financial centre. Moreover, what is seen to be of fundamental importance to the achievement of that objective is that the UK financial market as a whole improves its focus on quality control. There is a high degree of concern at present, certainly amongst our contributors, that the London market proposition has been challenged over time by the volume of new entrants being prioritised at the expense of an appropriate level of control on the quality of those companies. Re-balancing this equation will not be easy if the number of IPOs continues to be constrained, but the quality proposition is seen as more important to the future of the London markets than the number of issuers which those markets service, or the identity or nationality of the LSE’s ownership.

It is tempting and easy to allocate blame for the quality issue to the markets themselves, but the reality is that responsibility for maintaining the quality proposition is collective. It lies principally in the hands of the market participants, including the advisory community, with a role in bringing IPO candidates to market. The brand of the London market in general, and of the LSE in particular, is to a large extent reflective of the degree to which that responsibility has been discharged.

[1] Global IPO Trends, 2011, Ernst & Young

[2] “Leadership in a changing global economy: the future of London’s IPO market”, The London Stock Exchange, 2011

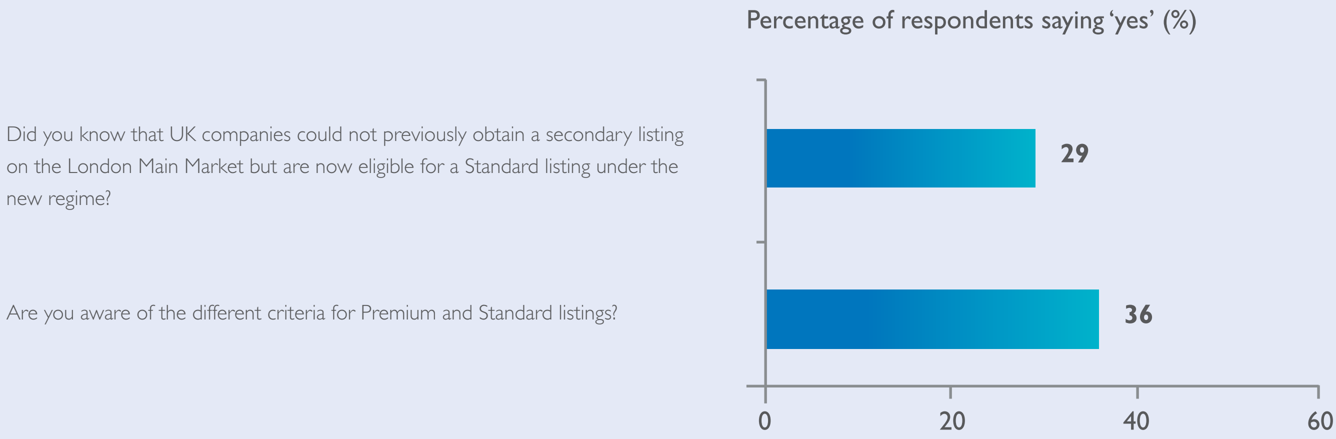
Chart 7: Attitudes towards the London Stock Exchange



As well as underlining the proposition that "quality carries a premium", the feedback from our contributors suggests that consideration needs to be given to whether the London market proposition is adequately understood, and whether (perhaps in that context) the strategy for communicating with key stakeholder groups is effective. Our research provides one striking example of why greater communication is necessary when considering the eligibility criteria for achieving a listing.

The distinction between Standard and Premium listing segments is a fairly recent initiative (April 2011), and one which owes its existence in its current form to the Financial Services Authority rather than the LSE. However, a sizeable majority of corporate decision makers indicate that they are currently not aware of the different eligibility criteria and continuing obligations for Standard and Premium listings. Furthermore, corporate decision-makers and advisors alike tend to feel that the new structure for listings on the LSE's main markets has not made the issue of eligibility any clearer than had previously been the case. Although it takes time for stakeholder perceptions, and their understanding of specific requirements, to bed down, it is clear that further consideration should be given to the different segments and their respective merits if only to rule it out as an impediment to future listing activity.

Chart 8: Corporate awareness of the eligibility criteria for Standard and Premium listings



We asked our corporate contributors whether they were aware that UK companies that could not previously obtain a secondary listing on the London Main Market were now eligible for a Standard listing under the new regime. Only 29% of corporate decision-makers said 'yes'. Similarly, only 36% were aware of the different criteria that exist for Premium and Standard listings. The comparative figures for decision-makers from quoted companies were slightly higher than those for non quoted companies, but not materially so.

DLA PIPER VIEWPOINT

"A challenge for the LSE in relation to the Standard segment is how to position it vis-à-vis AIM. A Standard listing requires no sponsor or other financial adviser, so a company may find it easier to achieve a quotation on a UK market via a Standard listing rather than via the AIM market (which requires the maintained appointment of a Nomad). If a Standard listing is seen overall as the "easy" route to London, the question which only time will answer is whether the light touch of the Standard listing, while attractive, will encourage a flight from quality which will prove to be detrimental."

Alex Tamlyn
Head of EMEA International Securities Group, DLA Piper UK LLP

INCREASING VALUE

Optimising the corporate governance framework requires a greater focus on the relationship between board composition and value enhancement. In any business merely re-balancing the risk/reward equation for directors will not in itself be sufficient

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Optimising the corporate governance framework requires a greater focus on the relationship between board composition and value enhancement. In any business merely re-balancing the risk/reward equation for directors will not in itself be sufficient.

In our 2008 report, we suggested that whilst much of the logic underpinning local corporate governance regimes was based around the reasoning that they should be capable of adding genuine value to a business, as well as supporting shareholder interests, it appeared in practice to be the case that corporate decision-makers were often not able to identify how the corporate governance regime was adding tangible value to their business. It was not unusual to find that the design and adoption of a governance framework owed more to a belief that it would provide a defence against regulatory enquiry rather than from any faith that it might improve the effectiveness and quality of the company's board and its decision making process. We also found that businesses were driven to creating a governance programme which was as similar as possible to those of their peer group, which is ironic given the emphasis placed by government, the regulators and the institutional investment community on the desirability of a "bespoke" approach which respects and reflects the individuality of particular companies and their operations.

It is clear, from the latest soundings we have taken on this issue, that there is still a good deal to be done in the UK if the effectiveness of our corporate governance framework is to be optimised.

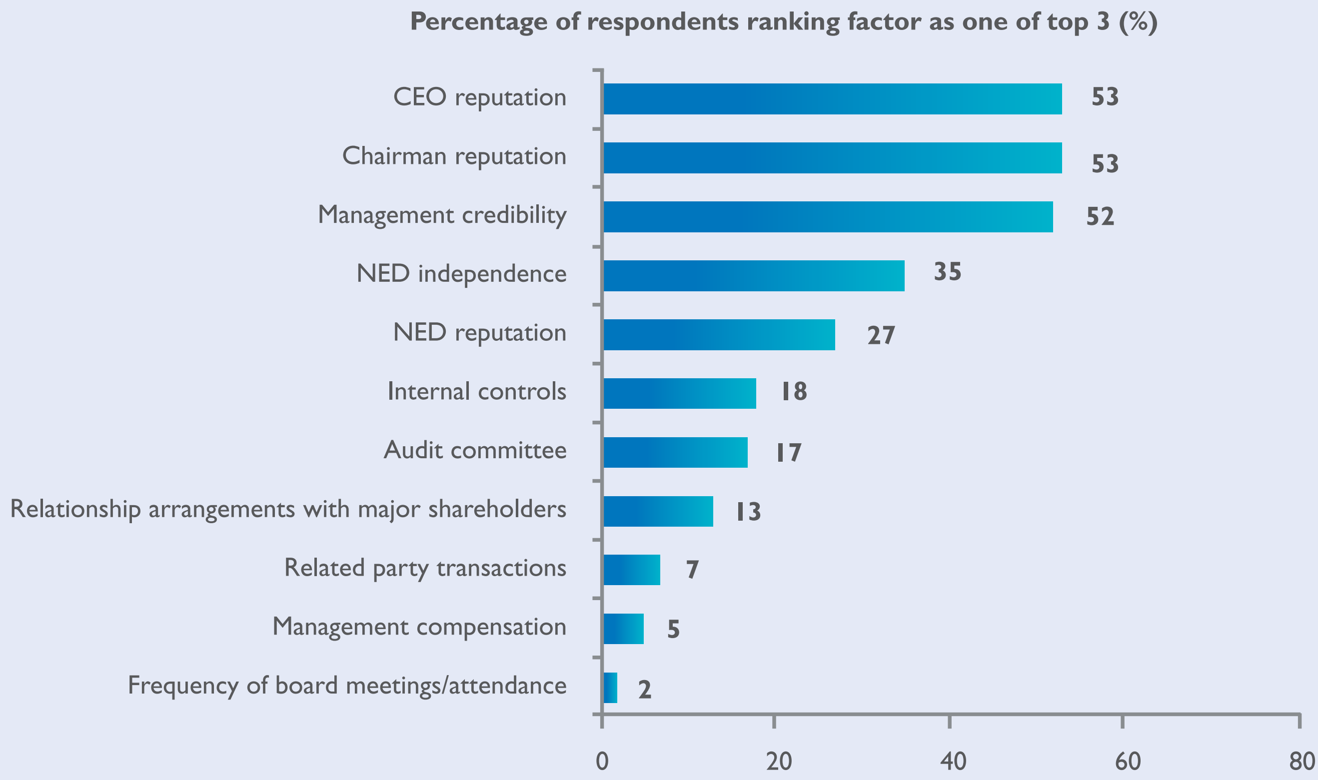
Our analysis suggests that perceptions around the role and potential benefits of corporate governance are moving forward. The proposition that corporate governance is a necessary feature of regulatory compliance, rather than an optional expense, is widely held by our contributors. In addition, the tangible benefits of an effective corporate governance framework are becoming better defined. Executive directors, non-executives and advisors alike, recognise the beneficial impact that effective corporate governance can have on the perceived quality of a business. And although corporate governance is still not generally thought to have a direct and positive impact upon a company's balance sheet and share price, it is acknowledged that there can be a virtuous effect on fundraising from a company having a strong team of non-executive directors in place on its board. This is particularly true for businesses from emerging markets, where the executive board members may be less familiar with UK governance custom and practice.

> **"Executive directors, non-executives and advisors alike, recognise the beneficial impact that effective corporate governance can have on the perceived quality of a business."**

In recent years though, it is apparent that much of the focus of the corporate governance debate in the UK has been around the risk/reward equation for directors. There is an on-going sense of concern that a proper balance is yet to be found. The uneasy tension that currently exists is clearly evident in the contrasting views we received from executive directors and non-executives on the issue, which emphasise the subjectivity of "appropriate", "justifiable", "fair", "legitimate" and "defensible".

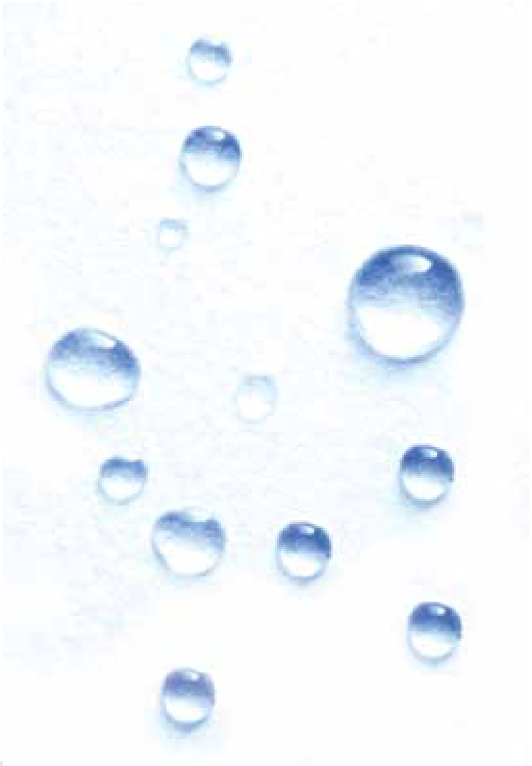
However, it would be a mistake to focus just on this one element, important though it may be. In fact, the feedback from our contributors suggests that there are other considerations of at least equal importance in designing a corporate governance strategy which is proportionate, credible, and value enhancing. The particular focus is on board composition.

Chart 9: Key factors in assessing the quality of corporate governance in a listed company



We asked our contributors what they considered to be the most important factors that should be taken into account in determining the quality of corporate governance in a listed company. As Chart 9 highlights, the key factors relate specifically to issues around board composition: most particularly, the reputations of the CEO and Chairman, the reputation and perceived independence of the non-executive directors and the credibility of the management team overall. Of lesser importance were the control, structure and process elements of the corporate governance framework.

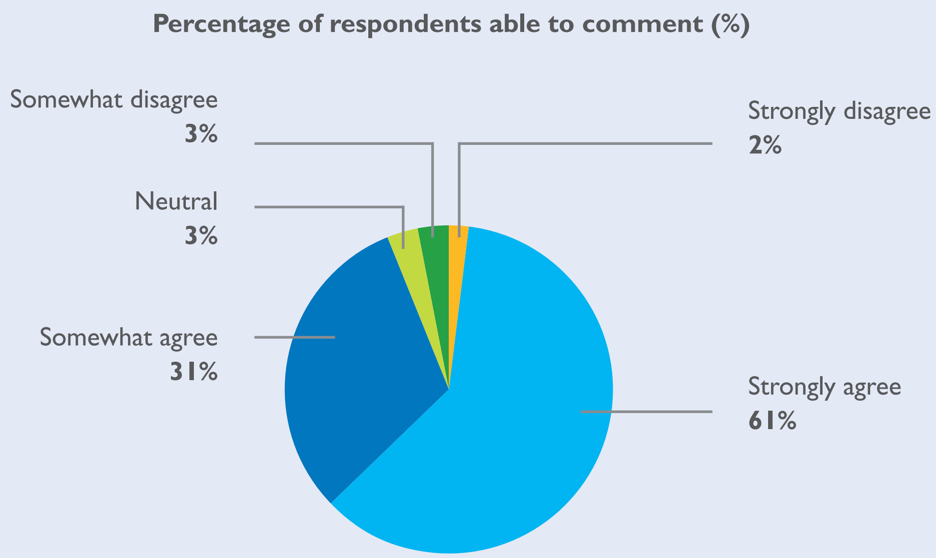
Indeed, our contributors were strongly of the view that board composition needs to be built around value enhancement rather than 'cosmetic compliance' or mere box ticking.



So, in this respect, it is clear that the key requirements for effective corporate governance are not just about ensuring that a board contains a particular proportion of non-executive directors, or that its overall composition meets a given gender or racial diversity threshold, (both of which are aspects which have received much media attention and which, coincidentally, are easy to measure) – but something rather more fundamental. Fundamental, yes, but at the same time less tangible and less easy to demonstrate in a binary manner – involving concepts such as ‘credibility’ and ‘reputation’, closely followed (but nevertheless followed, not preceded) by ‘independence’.

Some companies have clearly taken this message on board. However, only just over one in five have enlisted help to try to enhance the mix of non-executive directors on their boards. Thus, it seems that board composition, and specifically the need to ensure that the composition of a board genuinely adds value to the business moving forward, should be higher up the corporate agenda. Whilst re-balancing the risk/reward equation will do much to encourage the supply of candidates for non-executive positions, it is only a proper focus within individual companies on the specific composition of the board that will ultimately add value to the business.

Chart 10: Perceptions of the requirements for board composition to be built around value enhancement



We asked contributors for their reaction to a specific statement around board composition: whether board composition should be built around value enhancement, rather than mere box-ticking. The suggestion behind the question was that investors would respect an intelligent explanation for the assembly of eclectic boards, rather than pro forma (but potentially anodyne) code compliance. It is clear from the feedback received that there is strong demand for board composition to be focused on generating tangible value and not just diversity for diversity's sake.

OUR CONCLUSIONS AND RECOMMENDATIONS

OUR CONCLUSIONS AND RECOMMENDATIONS

The key issues, difficulties and challenges presently affecting the capital markets landscape in the UK have generated considerable comment across the financial and business community. However, in many cases, the solutions required to address these matters are less than obvious and can generate more controversy than the issue itself. The current IPO model, for example, appears to represent a classic example of a 'problem' that needs to be addressed, but for which there is little consensus about the best way forward.

We should pause for a moment before developing this. Our report is entitled "Restoring the Markets in a Financial Crisis". We recognise that there is something in need of being restored, because we have a sense of perspective and we can remember when there were 'better' times, which we might associate with such signs as greater liquidity, rising share prices, high volumes of new issues and year on year profit increases. We also recognise that there is currently a widespread economic crisis, which we might similarly define using criteria which are subjectively important to us – the difficulty of obtaining personal or commercial credit or employment, instability in supply chains, falling stock prices, the threat to the Eurozone, the collapse of high profile financial institutions, and so on. It is not just commonplace, but probably also appropriate and necessary, in order to make sense of a problem which is as complex and subtle as it is widespread, for us to seek to define the financial environment in a personal and 'bite-sized' manner. It is not just individuals who do this – companies, governments and countries often behave in the same way. Plenty has already been written in answer to the question "what in simple terms is the problem?" and "what specifically can I do to fix it?"

Certainly we need answers to those questions, but we have to acknowledge that they will not amount to a complete solution and they are by definition a compromise. One of the themes of this report is to demonstrate the existence and importance of aspects of the problem which are not conveniently tangible or measurable and which do not necessarily lend themselves to a precise solution which is easy to describe and deliver. The imperative for us is to acknowledge that they are a fundamental part of the problem and to keep them in mind as we work to address it.

For our part, we see the following as priorities if the UK capital markets are truly to get back on the right track.

AVOIDING A SHORT TERMIST RESPONSE

Whilst it is true in life that a simple solution often provides the most effective answer to a difficulty that is proving especially intractable, the feedback from our contributors is helpful in reminding us that it can be dangerous to assume that an 'obvious' solution is always the right response. Indeed, in highlighting their concern about the potential effect of incentive fees, our corporate contributors were also strongly of the view that if bank fees were tied to aftermarket share prices, which typically they are not at present, that would more closely align the interests of investors and advising banks in the IPO process. The trouble with this 'solution', however, is that it might itself incentivise manipulation of the market. "Be careful what you wish for" was a notable cautionary response from one of our contributors on the advisory side, a sentiment with which we have a good degree of sympathy. The somewhat mixed views we received from contributors on the relative merits of the current approach to bookbuilding also demonstrates the inherent difficulty of identifying one simple solution.

Indeed, if we question what really lies at the heart of the perceived 'problem', we are forced to conclude that we must give up a quest for a quick cure in favour of a longer term strategy. Whether the central issue underpinning the suboptimal IPO model is one of perception or reality, the feedback from our contributors suggests it is the breakdown in the level of partnership between market participants, and the trust deficit that now exists, that is at the root of the difficulties being experienced. To us, the evidence strongly suggests that measures to deal with the specific results and consequences of the problem will not in themselves be sufficient to address the concerns being expressed, although a series of small steps in the right direction can often be helpful in building an environment where trust can develop. In this respect, the London Stock Exchange's recent recommendations[1] for more independent pre-IPO research, earlier and deeper

Note: [1] "Leadership in a changing global economy: the future of London's IPO market", The London Stock Exchange, 2011 investor engagement with pre-IPO companies and publication of IPO fees (including incentive fees) within IPO prospectuses all represent sensible suggestions that should be followed through. Nevertheless, an effective solution to the current issues around the IPO model requires an actual change in the mindset, and behaviour, of the participants in the process. There is certainly a process to be followed, and the checklist environment which is intrinsic to the listing process is essential to ensure standardisation between markets and geographies as businesses seek to operate, and to raise funds, amongst a wider audience. But the danger of such an environment is that it encourages the mindset that "I did all I could" (for which read "I ticked all the applicable boxes"), and is inimical to best practice. We need to ask not just "Is it good?", but "Is it good enough?"

GETTING THE RIGHT BALANCE

Our contributors' feedback also confirms just how important it is for the right balance to be achieved by the regulatory authorities, as well as by key institutions such as the London Stock Exchange. For example, the current emphasis on a 'top down' approach to regulation, without at the same time seeking to foster the interaction between market participants, is unlikely to make any significant contribution towards resolving the current trust deficit that appears to be at the heart of many challenges within the capital markets arena. Similarly, a focus on the risk/reward equation for directors, without a parallel emphasis on the need for value enhancement within board composition and participation, rather than just on pure statistical measures around the composition itself (such as the mix of executive/non-executive representation and the extent of ethnic and gender diversity), is unlikely to sustain the market leading corporate governance framework which will benefit companies in the UK going forward. There is no denying that the compensation issue is important, but we must guard against focusing too closely upon one symptom of a more systemic problem.

The challenge for the London markets is also much about achieving the right balance. Critical mass is clearly important, but the strength of the London markets proposition, and that of the LSE in particular, depends on retaining a true focus on quality. We would stress that the responsibility for realising this 'quality objective' is not something that rests with the LSE alone. Indeed, it can only happen with the support of the market as a whole. Market participants, including the advisory community, must continue to develop the framework within which the quality proposition can flourish and act as a key differentiator. This requires a high degree of focus, including in the marketing of the LSE, to maintain appropriate visibility, profile and differentiation, all with the objective of achieving clear messaging in communications to key stakeholder groups. The feedback from our contributors, including that on the awareness and perceptions held of listing criteria, suggests that there is continuing work to be done in this particular area.

RIGHT ADVISOR, RIGHT ENGAGEMENT

Back in 2008, when we reviewed the feedback given by contributors to our initial capital markets report, it was apparent that the choice of professional advisor was an extremely important element of any decision to raise funds in a public context. In order to make a fully informed decision about their corporate finance strategy, we stressed that companies needed to make sure that they had access both to debt and equity market advising expertise. In addition, they needed to engage with their advisors from the outset and to ensure they were aware of the full range of products and options available.

The continuing relevance of this theme, from the feedback we have received from our 2011 contributors, is beyond doubt. A degree of imperfect information still exists within the capital markets, as seen, for example, in the relatively low levels of awareness of MTN programmes (as well as, possibly, within widespread perceptions about the unsuitability of different financing methods). Whilst this 'information gap' remains, the corporate sector as a whole is unlikely to be consistently able to make fully informed decisions about financing strategy. Moreover, the current trust deficit within the capital markets arena suggests that corporate decision-makers may give increasing consideration as to where they can best receive a genuine level of independent thinking and objectivity of advice. We would also suggest that any approach to the use of incentive fees be made on a case-by-case basis, with due prior consideration and analysis as to whether it will create any conflict between short term and longer-term objectives.

Equally, however, there is a real onus on advisors to look critically at the engagements they take on and the advice and guidance which they provide. Unless there is a good match between the mind sets of issuer and advisor, it becomes increasingly difficult to ensure that client expectations are managed properly and that corporate selling messages are optimised. It also becomes more challenging for the market as a whole to ensure that the quality of new issues is maintained. It is that which, as the feedback suggests, is central to the continuing strength of the UK capital markets proposition.

HOW WE CONDUCTED THE RESEARCH

The research on which our report is based was conducted as an online survey, with a broad range of questions covering four core areas: funding and investment strategies; the IPO model; the future of capital markets in the UK; and the requirements of effective corporate governance. The sample for the study, put together with the assistance of Hanson Green (a member of the Directorbank Group), focused on executive and non-executive directors of leading UK companies and was supplemented by a broad range of senior contacts working within investment banks, brokers and other corporate advisors.

In total, 106 respondents contributed to the findings set out in the report, with an almost equal mix of executive and non-executive decision-makers, as well as a healthy number of advisory contacts. Within the corporate segment, over one in four of the responses came from decision-makers in organisations with an annual turnover of at least £1 billion; and there was also good representation from the mid market and smaller corporate categories as well (see Chart 11). And whilst the Financial Services industry was the single most represented sector within the corporate sample (see Chart 12), our report has also benefited from a positive response from other sectors such as Industrials, Energy, Retail and Consumer and Technology and Telecommunications. A solid majority of the companies contributing to the report indicated that they were listed on a stock exchange.

Chart 11: Our sample of UK corporates, by annual turnover

Percentage of respondents (%)

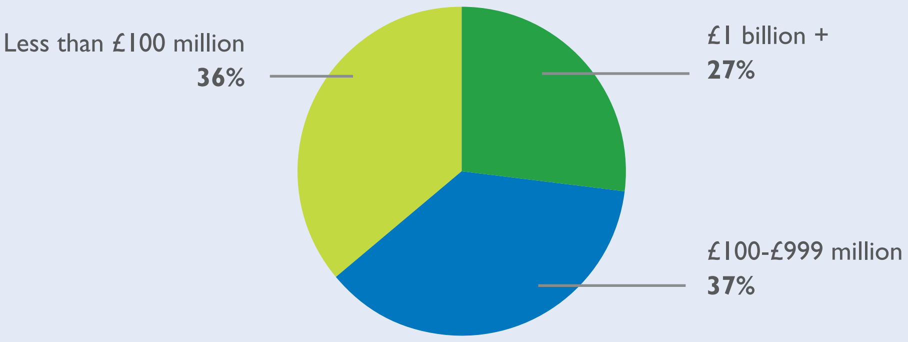
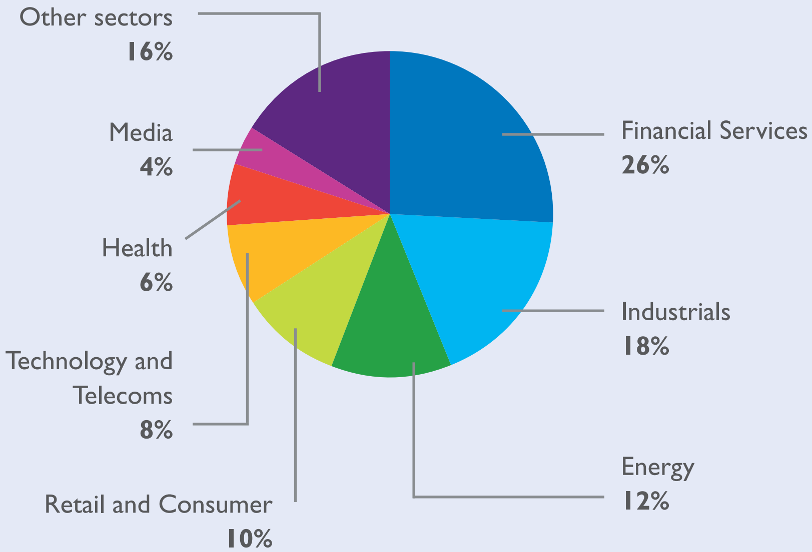


Chart 12: Our sample of UK corporates, by business sector

Percentage of respondents (%)



COMPANY PROFILES

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Hanson Green is a specialist search firm with a market leading position in the appointment of non-executive chairmen and directors. Whilst the firm's unique, in-depth experience lies mainly in this area, Hanson Green has also completed numerous other board level assignments at the request of its clients.

Founded in 1989, Hanson Green was a pioneer in identifying the need for professionally-appointed non-executive directors and has been a key contributor to the ongoing debate on corporate governance best practice ever since. They co-founded the Henley Centre for Board Effectiveness and have worked with the Cass and Warwick Business Schools on corporate governance thought leadership.

Hanson Green's proven track record of solving clients' recruitment challenges, combined with the unrivalled quality of its service, has made them a search partner for a wide range of FTSE and AIM quoted companies based in the UK and overseas. As experts in board composition, they have always promoted the value that diversity of thinking, experience and perspective can bring to a board. As such, they have been closely involved with the consultative process feeding into Lord Davies' review of Women on Boards, and of their non-executive placements over the past 24 months, nearly a quarter have been women. They have also placed the first woman on the boards of four FTSE 250 companies in the past twelve months.

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