Oxera

Agenda

Advancing economics in business

The cost of raising capital: an international comparison

Companies have increasing flexibility in deciding where to raise public equity capital and where to list and/or trade the securities they issue. This article examines the cost of raising equity capital in London's equity markets (the London Stock Exchange's Main Market and AIM) compared with the other two major European stock exchanges (Deutsche Boerse and Euronext), and with the New York Stock Exchange and Nasdaq in the USA

Equity markets are becoming more integrated, and the automatic tie between the 'home' geographic market of a particular company and the location of the equity market is loosening. As a result, companies have more choice about where they can raise equity capital, and list and trade the securities they issue.

The decision of where to raise equity capital and list is influenced by a range of factors, including the size and openness of the market, the depth and breadth of expertise available in a financial centre, and the costs involved in the capital-raising and listing process. Different financial centres and their listing venues can be expected to vary along these dimensions, and hence also in their relative attractiveness for companies seeking to raise funds.

While studies undertaken thus far have examined the determinants of listing decisions, including why companies seek to go public or obtain a listing abroad, there is little systematic analysis of the comparative costs of raising capital and listing in different financial centres. This article examines the cost of raising equity capital in London's equity markets (the London Stock Exchange's (LSE) Main Market and AIM) compared with the other two major European stock exchanges (Deutsche Boerse and Euronext), and with the New York Stock Exchange (NYSE) and Nasdaq in the USA. It is based on a recent study conducted by Oxera on behalf of the City of London Corporation and the LSE.

What determines the cost of raising equity in different markets?

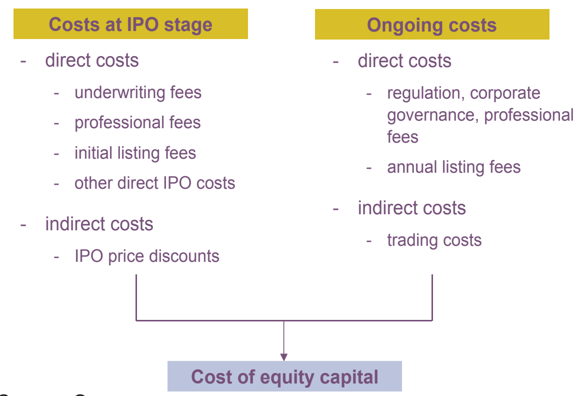
A company's cost of equity capital is determined by the net return required by investors, as well as the various costs associated with raising capital that drive a wedge between net required returns and the cost of equity capital faced by the company. Some of these costs depend on the geographic location of incorporation of the company and are incurred irrespective of where the company decides to raise and list equity, and vice versa.

Figure 1 summarises the main elements of the costs that can be linked to the geographic location of listing and raising capital. The costs can be incurred at the initial capital-raising stage, or they may be ongoing. While shown for initial public offerings (IPOs), the costs equally apply to subsequent issues of equity.

The costs at the initial issuing stage can include the fees charged by investment banks in the underwriting process, the fees paid to advisers, accountants and lawyers in preparing for the issue, initial listing fees, and marketing costs. In addition to these direct costs, there are indirect costs arising from an underpricing of the issue—or the price discount in the offer price compared with the first-day closing price.

Beyond the initial costs, raising capital in the public equity markets is also affected by a range of ongoing

Figure 1 The costs of raising equity capital



Source: Oxera.

This article is based on Oxera (2006), 'The Cost of Capital: An International Comparison', report prepared for the City of London Corporation and the London Stock Exchange, June. Available at www.oxera.com.

costs facing companies and their investors—eg, the costs of trading in the secondary markets, fees levied by exchanges and intermediaries, and the costs associated with meeting regulatory and corporate governance standards.

How do the European and US markets compare in terms of these elements of costs, and what are the cost-of-equity implications for companies if they decide to raise and list equity in one market as opposed to another? Put differently, if company X wished to raise £20m or £100m, what costs would it incur in London compared with New York, Paris or Frankfurt?

No data points are available where companies have simultaneously raised equity on these markets. However, the costs incurred by companies raising capital in the different markets can be analysed. The following sets out the main empirical findings of this comparative cost analysis.

Cost differences at the IPO stage

Underwriting fees generally constitute the single largest direct cost element when issuing equity. These are usually expressed in percentage terms as a gross spread charged by the underwriting syndicate—ie, the syndicate receives a certain percentage of the issue price for each share sold.

Analysis of IPOs from January 2003 to June 2005 shows that gross spreads of IPOs on the US exchanges are highest, averaging 6.5% of issue proceeds for IPOs on the NYSE and 7% for Nasdaq IPOs. In comparison, spreads on the LSE's Main Market are 3.25%, and those on AIM are 4%.

Table 1 shows these results on a disaggregated basis for domestic and foreign IPOs on the exchanges. There is no systematic difference between domestic and foreign issuers, and the overall conclusion of higher underwriting fees on the US exchanges continues to hold. The results for Deutsche Boerse and, in particular, Euronext suggest somewhat lower underwriting fees for IPOs in these markets. However, the sample of IPOs for which underwriting fee data was available is small—previous studies show that underwriting fees in the UK and rest of Europe are very similar (between 3% and 4%) and significantly lower than those in the USA.[1]

The main conclusion, therefore, is that flotations on an exchange in the USA come with higher underwriting fees than those in Europe. For an issue raising £20m, the typical underwriting fee in the UK, Germany or France would be around £700,000 (3.5%), compared with more than £1.3m (6.5%) in the USA.

Underwriting fees generally constitute at least half of all direct IPO costs. Given their importance, the Europe/US differences are likely to have a more significant impact on the comparative cost of raising equity in different markets than differences in the other direct costs.

In particular, initial listing fees charged by the exchanges constitute a negligible amount of the total cost of raising new equity—often less than 0.1% of the amount issued, regardless of the exchange on which the securities are listed. Other direct IPO costs include legal, accounting and advisory fees, as well as marketing and PR costs. Taken together, these tend to add another 3–6% for most issuers, but depend on issuer-specific factors such as the amount of funds raised. Data on these costs is not available in the public domain, and there was no quantitative evidence to suggest significant differences in these costs between the listing venues, although the firms and professionals that were consulted as part of the research noted that the costs in London may be somewhat higher than in Frankfurt and Paris, but not as high as in New York. The higher legal and auditing costs in the USA were largely attributed to the costs of complying with the requirements of the Sarbanes-Oxley Act 2002 (SOx), as discussed below.

In addition to the direct costs, discounts on the IPO offer price can be a significant indirect cost ('money left on the table'). For the average IPO, underpricing, as measured by first-day returns, amounts to 10–15% or more (based on existing academic evidence and new empirical analysis—see Oxera, 2006). Estimates of initial returns

Table 1 Underwriting fees for domestic and foreign IPOs

	Domestic companies		Foreign companies	
	Sample size	Gross spread (%)	Sample size	Gross spread (%)
UK: Main Market	28	3.3	5	3.5
UK: AIM	43	3.5	8	4.9
USA: NYSE	74	6.5	14	5.6
USA: Nasdaq	192	7.0	28	7.0
Euronext	7	1.8	–	–
Deutsche Boerse	6	3.0	–	–

Notes: No data was available for foreign IPOs on Euronext and Deutsche Boerse. On Euronext, foreign IPOs include IPOs by companies outside France, the Netherlands, Belgium and Portugal. Median values of gross spreads are reported.
Source: Oxera (2006), op. cit.

differ markedly over time, making a cross-market comparison difficult. Importantly, there is no evidence to suggest that IPOs in the USA are less underpriced than in Europe—ie, the higher underwriting fees do not seem to be compensated by lower discount levels.

Overall, in relation to quantifiable IPO costs, the evidence suggests that issuing equity on the London markets is cheaper than on the NYSE or Nasdaq, mainly because of the systematically higher underwriting fees charged for US transactions. London's position is similar to that of Euronext and Deutsche Boerse.

Differences in ongoing costs

Investors requiring a certain net rate of return on their investments will be willing to pay higher prices for shares if the transaction costs incurred when buying or selling the shares are lower. The costs incurred by investors trading in the secondary markets therefore have direct implications for market valuations and companies' costs of raising equity.

Comprehensive data on direct trading costs (brokerage commissions and exchange fees) and indirect costs (liquidity as measured by effective spreads or market impact) for the different markets is not available. However, trading cost data collected by Elkins/McSherry during 2004 and 2005 suggests the following.

- The direct costs of trading (brokerage commissions and fees) incurred by institutional investors differ significantly across countries. The direct trading costs, excluding stamp duty on UK equity transactions, were between 0.7bp and 3.4bp lower on the LSE than on the other exchanges.

- The 'market impact' measure of indirect trading costs suggests that the NYSE had the lowest costs, followed by Deutsche Boerse, Euronext (France), the LSE and Nasdaq.

- Overall, total trading costs incurred by institutional investors in the sample were lowest on the NYSE (23.5bp), followed by the LSE (25.5bp excluding stamp duty). Total trading costs in France and Germany are similar (27bp), with Nasdaq having the highest costs (30.8bp).

In addition to differences in the IPO costs and ongoing trading costs, markets differ in their regulatory and corporate governance frameworks. In principle, the impact on the cost of raising equity capital can be both positive (better frameworks signal quality and are valued by investors) and negative (adherence to stricter standards imposes compliance costs on companies). For small companies, this trade-off is likely to be less relevant, with decisions dominated by the need to gain access to capital in the first place—the flexible listing regime of the LSE's AIM may provide the only option of raising public equity capital, and relax longer-term financing constraints that may be present if finance sources were restricted to private equity or bank finance, for example.

For other companies, the choice of market can have implications for the cost of raising equity. In particular, since investors value corporate governance and tend to require lower returns from well-governed companies,[2] listing on an exchange that imposes stricter standards may help companies to signal to investors their commitment to better governance. The UK is generally ranked as the leading country in terms of corporate governance; accordingly, a listing on London's Main Market should deliver the greatest benefits in this respect, closely followed by the USA, with Germany and France ranking further behind.[3]

These benefits must be set against the costs that companies incur when complying with rules and standards. Although the full impact is yet to be assessed, the recent US corporate governance reforms implemented by the SOx have increased the costs of a US listing. The compliance burden resulting from the SOx has been quantified in numerous studies,[4] and there is evidence of a negative impact of the SOx on both IPO activity and the number of listings of foreign companies on the US exchanges.[5]

The SOx may have improved governance standards in the USA, but there is no evidence to suggest that the new regime delivers benefits beyond those that arise under the UK regime. Hence, as regards corporate governance, the increase in US compliance costs has made listing and raising equity capital in the London markets more attractive.

Concluding remarks

The costs of raising equity differ across the international financial centres and their stock exchanges. While it is not possible to quantify the implications of these differences for the overall cost of equity for issuing firms, there is evidence to determine the relative attractiveness of different locations in terms of key cost elements. The main differences relate to underwriting fees and the costs associated with meeting regulatory or corporate governance requirements—on both counts, the evidence indicates higher costs of raising equity for the aggregate of issuers in the USA than in London and the other European exchanges.

Specific companies can of course incur costs that are very different from the aggregate costs observed in the market—eg, depending on their size, industry affiliation and country of domicile.

– *Size*—most of the costs associated with raising equity in public markets decline proportionally as the size of the issue increases. Smaller companies may have no access to, or no realistic choice in where to access, public markets.

– *Industry affiliation*—by choosing to raise capital in a market with a strong clustering of analyst and investor expertise in a particular industry, companies may be able to achieve higher valuations and reduce their cost of raising capital compared with other markets.

– *Country of domicile*—stronger cultural integration between the location of raising capital and the country of domicile is likely to reduce informational problems on the part of investors, resulting in lower costs associated with raising capital. For example, companies from countries that are English-speaking, or that follow the more Anglo-Saxon legal and institutional frameworks, may incur lower costs of raising equity in the UK or US markets than on Euronext or Deutsche Boerse. Similarly, company-specific financial and economic links with the host country can explain capital-raising and listing decisions for specific companies.

The research analysis did not draw a link between cost differences and actual capital-raising decisions. Evidence shows that, in 2005, the European exchanges raised more new money from IPOs and attracted more international IPOs than the US exchanges. The increase in European IPO activity was largely driven by activity on the LSE, which saw more IPOs than the US exchanges combined, and in particular the AIM, which accounted for 52% of total European IPOs in that year.[6] This evidence is consistent with the identified cost differences, and the success of the LSE relative to the US exchanges has been attributed to costs (ie, those associated with the SOx).

However, further research would be required to investigate the extent to which issuing firms are sensitive to differences in costs, what costs they consider the most relevant, and to what extent they choose between markets on the basis of which location offers the lowest costs.

---

[1] For example, Torstila, S. (2003), 'The Clustering of IPO Gross Spreads: International Evidence', *Journal of Financial and Quantitative Analysis*, **38**, 673–94.
[2] See, for example, McKinsey & Co (2002), 'Global Investor Opinion Survey'.
[3] For corporate governance rankings, see FTSE Research (2005), 'FTSE ISS Corporate Governance Rating and Index Series: Measuring the Impact of Corporate Governance on Global Portfolios', April, or Governance Metrics International (2005), 'GMI Releases New Global Governance Ratings', press release, March 6th.
[4] For example, Financial Executives International (2005), 'Sarbanes-Oxley Compliance Costs Exceed Estimates', press release, March. Further studies are reviewed in Oxera (2006), op. cit.
[5] For example, PriceWaterhouseCoopers (2006), 'IPO Watch Europe: Review of the Year 2005', and Epstein, D. (2005), 'Farewell, Auf Wiedersehen, Adieu …', *Wall Street Journal*, February 9th.
[6] PricewaterhouseCoopers (2006), op. cit.