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RANDOLPH B. COHEN
JOSHUA B. SANDBULTE

The Children's Investment Fund, 2005

On April 7, 2005, Chris Hohn (HBS MBA '93), founder and portfolio manager of The Children's Investment Fund (TCI), stepped out of a confrontational closed-door meeting with German stock exchange Deutsche Börse's CEO Werner Seifert and Chairman Dr. Rolf Breuer. TCI was one of Deutsche Börse's largest shareholders, with roughly 8% of the total shares outstanding. The CEO rejected TCI's call for changes to the composition of the governing Supervisory Board of Deutsche Börse.[1] Following the meeting, the CEO also published an 8-page public letter addressed to Hohn presenting management's own governance and capital management plan (see **Exhibit 1**). The letter was the latest development in an ongoing battle between the German management team of the world's largest publicly-traded stock exchange and an upstart British hedge fund investor.

Since TCI's founding sixteen months earlier, Hohn's team had enjoyed remarkable success. Focusing primarily on long-short investing in western European mid and large cap stocks, TCI had achieved outstanding returns by applying simultaneously a value and catalyst-driven approach to investing.

TCI's large investment in Deutsche Börse served as an example. By leading a public shareholder revolt opposing Deutsche Börse's acquisition of the London Stock Exchange (LSE), TCI had prevented the merger and sparked a rally in Deutsche Börse's common stock.

Reflecting on the recent founding of TCI and the developments of its largest investment in Deutsche Börse, Chris Hohn knew that he needed to decide quickly on his next course of action. After the recent rise in the share price, should TCI begin to realize a profit from its ownership in Deutsche Börse? Or should TCI continue to aggressively push further changes in strategy and corporate governance? Hohn's decisions would determine the direction of both Deutsche Börse and TCI for years to come.

[1] German corporations have both a Board of Managing Directors (Vorstand) and a Supervisory Board (Aufsichtsrat). The Board of Managing Directors acts as the operating management of the company and includes the CEO and CFO. The Supervisory Board is composed of representatives from shareholders and employees, and is responsible for hiring, monitoring and firing the members of the Board of Managing Directors, among other responsibilities.

Professor Randolph B. Cohen and Joshua B. Sandbulte (MBA '03) prepared this case. HBS cases are developed solely as the basis for class discussion. Cases are not intended to serve as endorsements, sources of primary data, or illustrations of effective or ineffective management.

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TCI's History

The Founding of TCI

Chris Hohn was the child of working-class Jamaican immigrants in the United Kingdom. After attending Southampton University and working for Cooper's and Lybrand, Hohn attended Harvard Business School (HBS) at the suggestion of an undergraduate professor, Maurice Pinto. After graduating with top honors from HBS, Hohn worked briefly for the private equity firm Apax Partners in Europe, and then returned to the United States to marry. Following a six-month job search, Hohn began working for Perry Capital in 1996, a large merger arbitrage and event-driven hedge fund in New York. In 1998, Hohn moved from New York to London to focus on European investments for Perry Capital. In June 2000, Perry Capital raised a European-focused fund managed by Hohn. The Perry Capital European Fund achieved superior performance of 20% per annum over three years with little volatility, winning the Eurohedge Event Driven Fund of the Year Award in 2001 and 2002. Based on the superior track record of the European Fund, Hohn left Perry Capital and, after six months of preparation, launched The Children's Investment Fund (TCI) in January 2004.

TCI's Clients and Investment Terms

In founding TCI, Hohn sought to continue the combination of value-oriented and event-driven investing which he practiced at Perry Capital's European fund. However, TCI departed radically from the typical hedge fund structure by imbedding philanthropic contributions into the fee structure of the fund. TCI committed a portion of its management and incentive fees directly into The Children's Investment Fund Foundation (CIFF), a related charity focused on helping children in poverty in developing countries.

TCI required investors to commit capital for 3 to 5 years at a time when the normal redemption notice for investors in European hedge funds was quarterly. TCI charged investors a 1% management fee for assets under management each year and an incentive fee of 13-17% on investment profits, depending on the capital commitment period. In addition, TCI charged investors a 0.5% per year of committed capital and an additional 0.5% if the investor's net return was above 11%, which was donated to the charitable foundation.[2] In effect, the total fees charged by TCI were roughly similar to the "two-and-twenty" fees charged by other top-ranked hedge funds.

While providing funds to CIFF, TCI did not limit its investment universe to "socially responsible" businesses. "We are not an ethical fund," Hohn explained. "We will invest in any sector. We told our investors we would maximize return." For instance, TCI felt free to own the securities of tobacco and defense companies. While "socially responsible" funds may find inconsistency in TCI's structure and investment universe, TCI embraced the contradiction. According to Hohn, "We believe we can do greater good by making more money and giving it away."

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[2] As an example, if an investor allocated £100 million to TCI, they would pay £1 million a year in management fees and £500,000 to £1 million to the charitable foundation, depending on whether net returns exceeded 11%. Finally, if the fund returned £10 million in profits, the investor would receive £8.3 million to £8.7 million and TCI would retain £1.3 million to £1.7 million of the profits as incentive fees.

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The Children's Investment Fund Foundation

CIFF applied a venture capital approach to philanthropy, achieving influence beyond the limits of its own resources by supporting unproven programs that had the potential to achieve broad support if successful. CIFF funded smaller, sustainable initiatives, followed by larger-scale support if the grantee achieved its objectives.

CIFF invested primarily in Africa and India, focusing particularly on HIV/AIDS prevention and treatment and on work with AIDS orphans. In 2005, CIFF had roughly $100 million available for distribution and was in the process of increasing charitable grants rapidly. The vast majority of its funds came from the allocated investment profits and management fees of TCI and TCI managed nearly all of CIFF's endowment for no fees.

CIFF was led by its President and Hohn's wife, Jamie Cooper-Hohn, a graduate of the Harvard Kennedy School of Government. While Chris Hohn remained involved in the strategy and goals of the organization, he chose not to be involved in its daily operations.

Combining Charitable Giving into a For-Profit Hedge Fund

From an investor's perspective, there were potential benefits and drawbacks to TCI's charity structure. On one hand, the "all-in" fees were no worse than alternative hedge funds with comparable track records. On the other hand, there were less management fees to be divvied up among the TCI team in order to attract and retain talented analysts and traders. Institutional investors also expressed concerns with public relations ramifications of investing in a fund that mixed for-profit and non-profit objectives.

During the initial fund raising process, several large, prominent U.S. endowments chose not to invest specifically because of the charitable structure. In one example, a U.S. endowment offered to pay higher fees if it could avoid contributing to the charity.[3] In the end, however, the strength of Hohn's previous investing record at Perry Capital attracted more than adequate capital and the fund was oversubscribed. The initial plan was to raise $500-700 million initially, which was committed by investors within two months of launch.

According to Hohn, the "halo effects" for TCI from being associated with CIFF were limited. Media articles often included a brief explanation of the charity. But most of the benefits were not tangible; Hohn believed TCI could have achieved similar investment performance without charitable giving. The primary purpose of giving publicly rather than privately was to make a statement to other hedge fund managers and wealthy individuals that, in an industry where tens of billions of dollars of profits are generated annually it was shameful that only a negligible part of this was given back to society charitably. Hohn wanted to see more hedge funds start their own charitable foundations.

The benefit for the business according to Hohn was internal rather than external. "This is a human resources business. The charity is a differentiator for us. If we can find high quality people, the charity is an excellent way to attract and retain some of them." Hohn also believed that in an industry where successful managers are often financially secure, the charitable aspect of their work

[3] Institutional investors appeared concerned that an investment in TCI could increase pressure for them to allocate more of their funds to "socially responsible" investments, complicating their mandates and coming at the expense of higher returns. [**Other concerns were that they would be perceived as making unnecessary charitable donations and potentially negatively perceived programs of the foundation**].

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provided a more meaningful motivation. "Money doesn't keep good people. You can see this across the whole industry."

Investment Approach

TCI's advantage was stock picking. TCI's investment portfolio was composed of long and short positions in tradable securities, usually common stock and other equities. In selecting securities, TCI combined a value investing and event driven approach. While the activist elements of its approach had garnered TCI notoriety, according to Hohn, TCI's success began with a value approach to investing. "From the start, our focus was long-term value investing."

Value Investing

For TCI, "value investing" involved several critical components. First and foremost, the price of a security had to differ significantly from TCI's assessment of the fundamental value of the business. According to Chris, success relied on the discipline to invest when the price-value gap, the market price for a security compared to its expected future earnings, offered a significant margin of safety to the investor.

Second, TCI formed its own independent view of a stock's value. This approach was predicated on the belief that public markets were not always efficient in their pricing of securities. "We don't let market price tell us what something is worth," a TCI manager said, "investing requires the confidence to act on your views." Forming an independent view of a securities value required "deep, fundamental work," such as talking to customers and people familiar with the industry. In valuing companies, TCI evaluated unlevered yields, the unlevered earnings or free cash flow of the firm divided by the enterprise value of the business (enterprise value equaled the market price of all ownership claims on the earnings of the firm, such as debt and equity). TCI also used comparable private market transactions as a valuation yardstick.

Third, TCI's approach to value investing required a long-term orientation. "Markets are efficient in the short-term," Hohn explained, quickly adjusting prices in sympathetic response to headlines. Instead, "we invest with a private equity mindset" with the expectation of holding securities longer-term. Most of the securities in the TCI portfolio were held for a "medium-term" of 1 to 3 years.

Fourth, TCI tried to own fundamentally strong businesses. For instance, TCI sought to invest in monopolies and oligopolies, which Hohn believed were less likely to suffer from declining returns on capital over time. TCI tried to identify businesses that benefited from structural barriers to entry. For instance, TCI invested heavily in the privatization of toll roads in Europe and in Asia.

Fifth, TCI limited its stock selection to securities in its own sphere of confidence. TCI avoided businesses in technology, telecommunications, and insurance, where they felt they were outside of their core competency or difficult to value the business as an outsider.

Event Driven Investing

While valuation was critical, TCI also looked for "catalysts" in a business that would bring the convergence of trading and fundamental value. Catalysts included already disclosed information or likely new events that would serve to cause a reappraisal of the company's value in the markets. For instance, an announcement to repurchase shares or a management change could lead to changes in

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expectations and valuations. Since overall fund returns were driven by the duration of an investment, as well as price movement, catalysts were important to generating superior returns.

Along with superior securities selection, TCI believed that its "activist orientation" created value for its investors. TCI attempted to have an active dialogue with management teams and encourage actions that maximized the share price through acquisitions, divestitures, share repurchases, and other corporate actions. TCI sought to be involved in a friendly and influential manner, but was willing to assume an adversarial relationship with management teams which it believed were not acting to the benefit of shareholders.

In combining value investing and activism, Hohn emphasized the former. "Good valuation and a strong business…is the bedrock."

Investment Universe

TCI chose to focus on the equity and debt securities of large-cap and mid-cap companies. TCI believed that mid-caps in particular represented an attractive investment universe because they tended to be under researched, not represented in major indices, and were often too liquid for funds with capital constraints. According to Hohn, "large-cap [stocks] are typically heavily researched," which limited the opportunities for significant disparity between fundamental and market value.

TCI placed the majority of its investments in Europe where significant operational and financial restructurings provided ample investment opportunities. TCI also pursued investments in emerging markets while limiting specific country concentration. "Being global is helpful," Hohn underlined, "as we can apply investment themes globally." TCI had two analysts focused exclusively on Asia. As an example, they had pursued investments in toll roads in Asia, an investment which had proven to be successful in Europe.

Portfolio Composition

TCI's €2.0 billion fund was composed of long and short positions, with a net long bias. Hohn maintained a net-long orientation because he expected the markets to rise over time. TCI exhibited an "absolute return" approach to constructing its portfolio, explicitly choosing to be opportunistic in its stock selection and avoiding comparison to industry benchmarks, such as the S&P 500 or other indices. There were no index matching objectives.

TCI was not a true "hedge fund" in that it did not seek to match its long and short positions. For TCI, the purpose of holding short positions was to create a profit center rather than to hedge against market risks or volatility of the long positions. According to Hohn, TCI's investors would be poorly-served by stock-picking focused on specific hedging goals. "A lot of people are paying for hedging volatility when they don't need it." Instead, TCI's emphasis was on fundamental stock-picking for both long and shorts, which it believed would generate greater returns for investors over the long-term.

Gross leverage (total value of long and short positions divided by initial capital) was required to stay below 200% of net asset value (NAV), the market value of total assets minus the market value of total liabilities, including short positions. This meant that for every euro of capital, TCI took long and short positions worth less than €2.00. The net long position of the portfolio tended to be 115-120%.

TCI also avoided diversification and instead concentrated in a few securities. TCI's investment terms allowed for up to 25% of NAV in a single security. Other competing hedge funds had the

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freedom in their investment mandates to concentrate heavily but often did not in practice; TCI's activist approach required concentration. According to Hohn, "the top five largest holdings will be in 70-80% of fund. [Concentration is] not just a theory." This also allowed TCI to place more money in its best ideas, which came infrequently. According to Hohn, "we try to have ten great ideas [a year]."

Organizational Structure and Investment Process

Hohn designed the TCI team to be a small and flat organization. He served as the Portfolio Manager of the Fund and was supported by six investment analysts. In addition, the office and operations were managed by a COO, CFO, and Office Manager (see **Exhibits 2** and **2b**).

In building his investment team, Chris looked for a limited number of experienced, high-quality people. Chris focused on finding experienced analysts with a value investing philosophy in picking securities. The office environment was completely open to encourage collaboration. The office was composed of two large rooms, with desks side-by-side. His most senior analyst, and a key contributor on the investment in the stock exchanges, was Patrick Degorce, whose background was as a top ranked long only mutual fund manager at Merrill Lynch.

Hohn and the analyst team spent half their time looking for new investment opportunities, and half of their time managing their current investment portfolio. Analysts generated ideas using their existing knowledge, databases searches, sell-side research, buy-side contacts, and company visits. TCI sought valuation outliers in good business irrespective of visible catalysts which was a change from the catalyst driven approach he had adopted prior to forming TCI. Analysts tended to naturally gravitate toward particular industry sectors, such as financial institutions (banks, stock exchanges) and infrastructure, but they were all generalists.

Deutsche Börse

In the beginning of 2005, Deutsche Börse represented one of TCI's largest positions, embodying both its value and event-driven approach to investing. Deutsche Börse was established in 1992 as the holding company for the Frankfurt Stock Exchange, the dominant stock exchange in Germany.

The Chairman of the Supervisory Board was the widely respected Dr. Rolf Breuer, Chairman and former CEO of Deutsche Bank AG and the CEO was Dr. Weiner Seifert. Seifert, an ex-McKinsey consultant, had been appointed CEO of Deutsche Börse in 1993. Under Seifert's leadership, Deutsche Börse transformed itself from the old Frankfurt exchange to an electronic share trading platform with integrated clearing and settlement.

Deutsche Börse demutualized in February 2001, becoming one of the world's largest publicly-traded securities exchange and related technology provider. Deutsche Börse's initial performance following its IPO had been positive, with a share price that rose from €34 to €50 within one year. From 2002 to 2004, Deutsche Börse stock price stagnated, with shares trading flat between the IPO price of €34 and €50.[4] With 111.8 million shares outstanding, Deutsche Börse had a market capitalization of €5 billion.

Deutsche Börse's primary business was operating cash market and derivates exchanges, Xetra and Eurex respectively. Xetra was a fully-electronic exchange for equity and debt securities, similar to the Nasdaq in the United States. Supporting Xetra was Deutsche Börse's Clearstream segment, which

[4] The per share dividend over this period was €1.69.

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provided post-trade settlement and other services to investors. The Eurex segment provided a similar integrated exchange platform for options, futures and other derivatives. Eurex also was "vertically integrated" into the clearing and settlement process. Deutsche Börse accounted for approximately 25% of the equity trading volume on the European stock exchanges and the highest trading volume of any international derivatives exchange, representing 1 billion contracts traded in 2004.[5] Deutsche Börse also had two additional reporting segments, Information Technology and Market Data & Analytics (see **Exhibit 3**). In 2004, all five of Deutsche Börse's units together generated €1,450 million in revenue, €459 million in EBIT, and net income of €266 million.

Deutsche Börse's Competitive Position

Deutsche Börse competed primarily with the largest financial market players worldwide. Unlike in the United States, where electronic exchanges, such as Instinet and Archipelago, had challenged the position of the dominant NYSE, European exchanges had been earlier adopters of electronic trading platforms and market models, limiting the competitive threat from entrants.[6]

Deutsche Börse's securities exchange business competed primarily with the London Stock Exchange (LSE) and Euronext, and the derivatives market business competed primarily with Euronext's London International Financial Futures Exchange (LIFFE).[7]

London Stock Exchange

Deutsche Börse's largest competitor was the LSE, the largest exchange in terms of trading volume among the European exchanges, and representing the second largest market in the world behind the NYSE in market capitalization of traded companies. The LSE's revenues came from cash trading operations (issuer and broker services) and information services. The trading operations collected fees from trading participants and listed companies, as well as fees for trades consummated. The information services segment collected fees from customers who used terminals accessing trading and pricing data. (See **Exhibits 4a, 4b** and **4c**.)

While LSE was larger in terms of trading volume and market capitalization of traded firms, Deutsche Börse had significantly greater profitability, with nearly four times the profits of the LSE in calendar year 2003.[8] LSE had failed to develop a derivatives trading business, which represented one of the more profitable trading markets to operate. LSE also had suffered from the internalization of some trading activity among the major investment banks, which had impacted trading volume growth.[9]

Prior to its 2001 IPO, Deutsche Börse and the LSE had attempted and failed to negotiate a merger, following approval by both of their boards. The combined Deutsche Börse-LSE entity would have created a giant stock exchange, capturing nearly 50% of the equity securities trading in Europe and

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[5] 75 million of 299 million equity trades in 2003. Deutsche Börse, "Creating A World Class Markets Company With Global Impact," PowerPoint presentation, January 27, 2005.

[6] George Chacko and Vincent Dessain, "Deutsche Börse," HBS No. 9-204-008 (Boston: Harvard Business School Publishing, 2003), p. 2.

[7] Ibid., p. 12.

[8] Deutsche Börse, "Creating A World Class Markets Company With Global Impact," PowerPoint presentation, January 27, 2005, accessed December 2005.

[9] Chacko and Dessain, *Deutsche Börse*, p. 11.

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rivaling the size of the NYSE. Negotiations broke down because of pressure from brokers, unresolved business and regulatory hurdles, and a bid from an interloper.[10]

Euronext

Euronext represented the other large competitor to Deutsche Börse in both the European cash market trading exchange and derivatives. In equities, Euronext trailed only the LSE in terms of European share trading. Like Deutsche Börse, Euronext performed central clearing and counterparty functions for trades on its exchanges, allowing users to transact anonymously and efficiently. While Deutsche Börse had internalized custody functions in Clearstream, the custody operations that supported Euronext were operated by an outside party, Euroclear.

Euronext also operated a large derivatives market (LIFFE), a competing derivatives market to Eurex. Euronext executed 566 million derivatives contracts in calendar year 2004, compared to Deutsche Börse's Eurex volume of over 1 billion.[11]

TCI's Investment in Deutsche Börse

The TCI investment team had been long-time admirers of the for-profit, exchange businesses. "We had identified early on that we liked exchanges," Hohn explained. "We viewed all these exchanges as the best businesses that you could own in Europe." As members of the TCI team had followed Deutsche Börse's development since its February 2001 IPO, they believed that its public market valuation did not reflect its full potential.

First, TCI believed that the earnings power of the exchange was underestimated. "Stock markets were just demutualized," Hohn said. "No one understood that they were unregulated businesses with massive barriers to entry." Before demutualization and public flotation, the exchanges customers were also their owners, which limited the earnings of the institutions. Therefore, historical earnings did not reflect their pricing power and secular growth. "All across the world, no one understood how valuable [exchanges] were."

Second, TCI believed that Deutsche Börse enjoyed a formidable competitive position due to liquidity and connectivity based network effects. Listing firms choose exchanges with the most buyers of their securities. Investors chose exchanges with high liquidity, which drove down the bid-ask spread (an implicit cost of a trade) and guaranteed the continuous ability to buy and sell securities at the best possible price.

Third, the derivative markets were more attractive than stock and bond exchanges, a strength of Deutsche Börse as the largest derivatives market in Europe. Derivative markets enjoyed better pricing power compared to cash markets, due to the greater fragmentation of their trading customers.

Fourth, Deutsche Börse's "back-office" clearing and settlement business also tended to be a dominant business.[12] Clearing and settlement required large, up-front investments in IT system integration by customers, limiting the customer's willingness to integrate with additional providers.

[10] Zhanna A. Zenina, Case Study: Merger of the London and Frankfurt Stock Exchanges, Harvard Law School, International Finance Seminar, May 14, 2001, p. 14 and Chacko and Dessain, *Deutsche Börse*, p. 6.

[11] "Statistics: Equity Markets," Europlace, http://www.paris-europlace.net/toc_stats_eq.htm, accessed January 2006.

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Fifth, the fixed-cost nature of the exchange and clearing business drove attractive returns on invested capital. The IT-based assets were deflationary (decreasing in cost over time) and scaled to accommodate many times the current trading volume without significant investment. This also meant that Deutsche Börse could grow revenues and earnings without significant incremental capital.

Sixth, Deutsche Börse's stock price was cheap. As of December 1, 2004, Deutsche Börse was trading at €45. A recession in Europe decreased trading activity and fees related to trading activities had fallen on a per-trade basis. TCI believed that the free cash flow yield to enterprise value for Deutsche Börse was 11-12%. Using a discounted cash-flow model (DCF) and comparing Deutsche Börse to its global comparables, TCI conservatively estimated that Deutsche Börse's intrinsic value was €100, 100% above the December 1, 2004 price of €45.

Risks with Deutsche Börse Investment

Several major risks were involved with the initial investment. First, there was what Hohn called the "corporate-governance discount." While Deutsche Börse CEO had a reputation as a capable and persistent leader, many investors were concerned that Seifert's vision of a pan-European exchange would be achieved through over-paying in an acquisition. After the failed LSE merger in 2001, Deutsche Börse had officially stated its continued interest in acquiring LSE. At the end of 2004, the Company also had a debt-to-equity ratio of 9%, compared with a ratio of 30% in 2000, making Deutsche Börse overcapitalized and giving the management team ample potential funds to make a purchase. Management did not own a material amount of shares.

Second, TCI had corporate governance concerns. Owners of German firms had a limited ability to influence management and firm decisions as compared to the United States and the United Kingdom, particularly concerning mergers. Typical German firms were composed of a Supervisory Board, representing both shareholders and employees, which elected and oversaw a Board of Managing Directors, composed of members of the management team. Selection and removal of management by shareholders was done indirectly through election of Supervisory Board members. Unlike in the United States and United Kingdom, only the Supervisory Board approved mergers, instead of a vote of the broader shareholder group.

Third, exchanges had regulation risk. As quasi-monopolies that served a critical role in the function of the financial markets, regulators represented key stakeholders of financial exchanges with significant power. There was always the possibility that regulators would impose regulations that could increase costs or limit pricing power.

Hohn and other members of the TCI investment team met with Seifert in August 2004. Following this meeting, TCI accumulated 1.8 million shares of Deutsche Börse common stock. When rumors related to a potential Deutsche Börse-LSE merger began to circulate in November 2004, TCI sent a letter to Dr. Rolf Breuer and Weiner Seifert encouraging Deutsche Börse to consider stock repurchases and cautioning against paying too much for any potential acquisitions.

[12] "Three-dimensional chess," The Economist, (August 4th 2005), http://economist.com/PrinterFriendly. cfm?story_ id=4257420, accessed December 2005.

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Post-Investment Developments

London Stock Exchange Acquisition Announcement

On December 13, 2004, Deutsche Börse announced its intent to acquire LSE for 530 pence per LSE share, a 49% premium to the average 3-month trading price of the shares prior to takeover rumors. With 275MM shares outstanding and minimal debt, the offer represented a purchase price of around €1.4B. Although the LSE initially rejected the proposal as inadequate, it invited Deutsche Börse to enter into further merger discussions. Shortly after this, Deutsche Börse announced that its Supervisory Board had granted its preliminary approval of a merger with the LSE.

Deutsche Börse's initial offer was 24x the consensus earnings estimates of 21.8 pence for LSE in 2005, and 13x 2005 earnings estimate of 39.5 pence per share adjusted for €75 million in run-rate synergies Deutsche Börse believed it could achieve by the third year of the merger.[13] To appease trading customers, Deutsche Börse also proposed reducing LSE's trading fees by 10%. While Seifert intended to finance the purchase with long-term debt, Deutsche Börse believed it could maintain its AA credit rating and start a share buyback program by 2007.

Hohn believed that the use of cash to acquire LSE was a misuse of Deutsche Börse's capital, as compared to the option to repurchase its own shares, which TCI believed were trading at a discount to intrinsic value. At 24x 2005E expected earnings, the purchase of LSE initially provided an earnings yield of roughly 4%. This compared to a free cash flow to enterprise value yield of 12% for its own shares. He was also concerned about the start of a bidding war with Euronext, another large TCI holding.

TCI contacted other large shareholders and found frustration with Deutsche Börse's underperforming share price, but different opinions of whether and how to oppose the merger. While some other aggressive hedge funds proved willing to participate in a public confrontation with management, many of the larger institutional investors were reluctant to take an adversarial position against management. Other shareholders did not oppose the merger at all, believing that consolidation among the exchanges was required and attaining the operating leverage associated with the combined entity was worth paying "full price" for the LSE.

TCI's law firm advised it of its options to oppose the merger, which appeared limited. First, Deutsche Börse's management team would be able to consummate the merger without shareholder approval according to German corporate law. Second, management could not be removed directly, as they were elected solely by the Supervisory Board. Instead, TCI could seek to replace the Supervisory Board.[14]

After weighing options, TCI decided to increase its ownership stake in Deutsche Börse to more than 5% and oppose the merger publicly. On December 22nd, TCI sent a letter to Werner Seifert asking Deutsche Börse to hold a shareholder vote on the proposed merger. Following this, TCI made a public announcement stating that it had requested a meeting of shareholders to vote on the removal of the Deutsche Börse Supervisory Board.

[13] €25 million a year in revenue synergies by the third year. Deutsche Börse, "Creating A World Class Markets Company With Global Impact."

[14] Proposals could be made by owners of more than 5% of the company for at least 3-months and would require a simple majority of shareholder votes, at the company's annual general meeting (AGM), scheduled for May 2005, or an extraordinary general meeting (EGM).

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A Bitter Public Dispute

TCI's call to sack the Supervisory Board of one of Germany's largest thirty public institutions set-off a firestorm in the press and among the politicians in both the United Kingdom and Germany. Critical and accusatory public letters were exchanged between Hohn and Seifert. Seifert referred to investors such as Hohn as "very short-termist" and "not very welcome in Germany."[15] Hohn, in turn, described Seifert as an "empire-builder" and ridiculed Deutsche Börse for being critical of hedge funds, analogizing it to an ice-cream salesman saying he hated children since hedge funds were a huge part of exchange trading.

TCI also accused Chairman Breuer of a conflict of interest, due to his simultaneous chairmanship of Deutsche Börse and Deutsche Bank, who was advising Deutsche Börse on the transaction. Hohn was quoted as saying "the guy who is supposed to be protecting shareholders is also providing financing for the deal and earning fees while at the same time Deutsche Bank owns lots of LSE shares…another example of the fundamental corporate governance problems Deutsche Börse faces."[16]

At the heart of the dispute was an adamant refusal of the Deutsche Boerse management to give shareholders a vote on the deal. Such a vote would have been mandatory in the U.K. and the Netherlands but was not mandatory under German law. Goldman Sachs, as advisor to the company, had apparently adopted a ''just say no'' strategy.

Politicians and the press amplified the public rancor. On one side, the London-based Daily Mail reported, "the rebellion highlights valid points about corporate governance at Deutsche Börse which conforms to German standards but which may not quite hit the mark in Anglo-Saxon terms."[17]

On the other side, the leader of the ruling Social Democrat party in Germany called foreign financial investors such as TCI "locusts," which "destroy everything and move on."[18] The CEO of MAN plc, the largest publicly-listed hedge fund in Germany, criticized TCI and suggested that they sell our shares if we did not like the actions of the management. "Shareholder engagement…should be handled with discretion…management are more prepared to move a position, when appropriate, if it isn't seen as a public issue."[19]

Large institutional investors in Deutsche Börse who usually avoided public disagreements with managements sent public and private letters to Weiner Seifert stating that they opposed the proposed terms of merger.[20] A subsequent public relations road-show by Deutsche Börse intended to sell the merger met with limited success as many of the largest investors refused to attend.

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15 "Saved by the growing power of hedge funds," Louise Armitstead, March 13', 2005, *The Sunday Times*, via Factiva, accessed October 2005.

16 "Fund calls on Börse to drop bid for LSE," Norma Cohen, February 3, 2005, *Financial Times,* London Ed1, p. 20, via Factiva, accessed October 2005.

17 Ruther Sunderland, "Mystery of hedge fund rebel," *Daily Mail*, January 25, 2005.

18 Wolfgang Munchau, Germany is soured by the politics of envy, May 2 2005, http://www.thelongwaveanalyst.ca /news/may2_05_germany.htm, accessed February 4, 2006.

19 Patrick Jenkins, "Man's boss Fink turns on rival TCI," *Financial Times*, June 28, 2005.

20 Ibid., institutional investors included Fidelity, Merrill Lynch Investment Managers and Capital International.

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During this period, many German-based investors sold their shares to Anglo-Saxon and other international investors (see **Exhibit 5**). According to public reports, shareholders agreeing with TCI's position opposing the merger owned between 50% and 60% of Deutsche Börse's stock.[21]

LSE Bid Abandoned

During this period, negotiations with the LSE failed to make progress, as the LSE demanded a higher purchase price. Squeezed between a vociferous shareholder base and an unwilling merger partner, Seifert conceded. On March 6, 2005, Deutsche Börse announced that it was withdrawing its proposed offer for the shares of LSE, but reserving the right to make an offer at a later time. (**Exhibit 6** presents a graph of the Deutsche Börse Stock price and a timetable of key events.)

Following the LSE bid withdrawal, Deutsche Börse also announced preliminary changes in corporate governance. A spokesperson said, "We will invite new shareholders to be part of the Supervisory Board," apparently beginning in 2006.[22]

Decision Point

On April 7, 2005, developments again crecendoed following the first meeting between Hohn and Seifert since the dispute regarding LSE began. After the meeting, Deutsche Börse released an 8-page letter addressed to Hohn refusing to make immediate changes to the composition of the Supervisory Board. At roughly the same time, TCI was notified that BaFin, the German stock market regulator, was opening an investigation into whether TCI and other investors broke securities laws in their opposition to the LSE bid by acting in concert to control the company.

Chris Hohn faced the decision of what do next. Deutsche Börse's shares had appreciated 47% since November 2004, giving TCI a sizable unrealized gain and now representing over 20% of the TCI fund's NAV. (**Exhibit 7** provides indexed stock prices for Deutsche Börse and London Stock Exchange.) Was now the time for TCI to begin to realize its investment? Was the public disagreement with the CEO of Deutsche Börse beginning to damage the company? And what were the broader ramifications for TCI's business due to a continuing public confrontation with a widely respected management team?

Or should Hohn continue to push for governance changes at Deutsche Börse? If so, what strategy should TCI pursue to bring about governance changes?

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[21] David Reilly and Edward Taylor, "Deutsche Boerse ends bid to buy London Stock Exchange," *Wall Street Journal*, March 7, 2005.

[22] "Deutsche Boerse Says New Investors Can Join Board," Bloomberg, March 18, 2005.

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Exhibit 1 Excerpts of Letter from Dr. Werner Seifert, CEO of Deutsche Börse, to TCI, April 7, 2005

Dear Mr. Hohn,

Commencing with the detailed public announcement of the Company's proposal to acquire the London Stock Exchange in late-January and culminating with our meeting today with you…we have been engaged in an extensive and private dialogue with a broad group of our shareholders regarding matters of importance to them …

The most difficult task before the Company today is the melding of a very broad range of shareholder opinions into a cohesive strategy. At the outset of our efforts to acquire the LSE…the nature of the concerns varied dramatically from one investor to the next. For example, only a handful of our 28,000 shareholders shared your concern that the LSE should not be acquired at any premium… Most believed a deal at or about our offer price was attractive.

In February, a significant change occurred in our shareholder base with the addition of many new investors from the hedge fund community. Over time, some large shareholders spoke with a loud voice in expressing their displeasure with our proposal to acquire the LSE. Some of these investors had been shareholders of Deutsche Börse for quite some time, while others, like TCI, had purchased the bulk of their shares after our proposal to acquire the LSE was announced…

On March 31, TCI demanded that we immediately remove and replace a majority of our Supervisory Board members with TCI's hand-picked nominees. More recently you demanded the removal and replacement of "only" a majority of the shareholder representatives on the Supervisory Board. Yet, despite the dramatic scope of the Board changes that you have demanded of us, you have told me on several occasions that you have "no specific strategy" for the Company…

After consideration of numerous alternatives, we have developed a comprehensive shareholder value enhancement program. Our plan precludes only the most extreme actions. It will consist of two principal elements; an alteration of the Company's capital structure with significant distributions to shareholders; and, improvements to our corporate governance processes and bodies…

Our capital management program is comprised of three components. The first is the distribution of available funds in the short term…In the second part of this program, as we have publicly announced, we are exploring possibilities to free additional funds for distribution to shareholders… The third component of our capital management program is the use of future cash flow generated by the company. We have already announced that we plan to increase the Company's dividend payout ratio, and to continue the share buy-back program…

We are convinced that the best interests of our shareholders will be served by making changes in the Supervisory Board election scheduled for 2006. A rushed and wholesale change in the composition of our Supervisory Board is not in anyone's best interest…In short, we think the time has come for an end to this drama and we hope TCI will agree to join with us in doing what is best for the Company, its owners, customers and employees.

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We are proposing the formation of a new Shareholder Committee…The Shareholder Committee will serve as a forum for shareholders to communicate directly with the Company's Executive and Supervisory Boards with respect to matters of importance to all shareholders…

We are confident that…our plan will serve as an effective model for good governance, and a value driver for shareholders. We also believe that, upon reflection, you will agree that our proposal provides all shareholders with increased accountability, while ensuring the continued success of our business. We ask that you join with us in supporting our Shareholder Value Enhancement Program and in avoiding the disruption, cost and distraction of a public spectacle.

Very truly yours,

Weiner Seifert

Source: http://www.finextra.com/fullpr.asp?pf=y&id=3919, accessed January 2006.

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Exhibit 2a Biographies of Key Management

Christopher Hohn

Christopher Hohn was the Portfolio Manager leading the European event driven investment strategy at Perry Capital from 1997 to the start of 2003. This strategy employed capital in the main Perry Partners L.P. fund from 1997 to 2003 and from June 2000 to May 2003 in the separate Perry Capital European Fund (PEF). PEF was awarded the Eurohedge Event Driven Fund of the Year in 2001 and 2002. He led the establishment of a London office for Perry Capital in 1998. From 1994 to 1995, he was an Associate at Apax Partners in London and from 1989 to 1991, a Manager in the Corporate Finance Division of Coopers and Lybrand in London. He joined Perry Capital in 1996.

He graduated from Harvard Business School in 1993 with an MBA (high distinction) and from Southampton University (U.K.) with a BSc. in Accounting and Business Economics (1st Class Honours). He is a Chartered Financial Analyst.

Patrick Degorce

Patrick Degorce has been with the Investment Manager as a Managing Director in equity research since January 2004. From 1997 to 2003 he was employed by Merrill Lynch Investment Managers (MLIM) in London as a director of Institutional European Equities and a Fund Manager. At MLIM, he managed in total approximately $1.8 billion of assets, including the MLIIF Euro Market Fund, launched in January 1999 which held over $700 million of assets in September 2003 and was ranked best European fund over three years by *The Financial Times* (Fund Management Supplement, September 15, 2003). From June 2002 through August 2003 he managed the MLIIF European Fund which held over $600 million of assets in September 2003. From June 2001 to September 2003, he also managed a £100 million asset non-benchmarked but fully invested fund for an institutional client.

From 1993 to 1997, Patrick was a banker at Credit Commercial de France in Paris advising on privatization programs in Eastern and Central Europe. From 1990-1991 he was a Sub-Lieutenant in the French Navy's Foreign Affairs Department in Paris. He has a BA in Political Sciences (1990) and an M.Phil in Economics (1992) both from the Institut d'Etudes Politiques. He is a Chartered Financial Analyst.

Source: The Children's Investment Fund.

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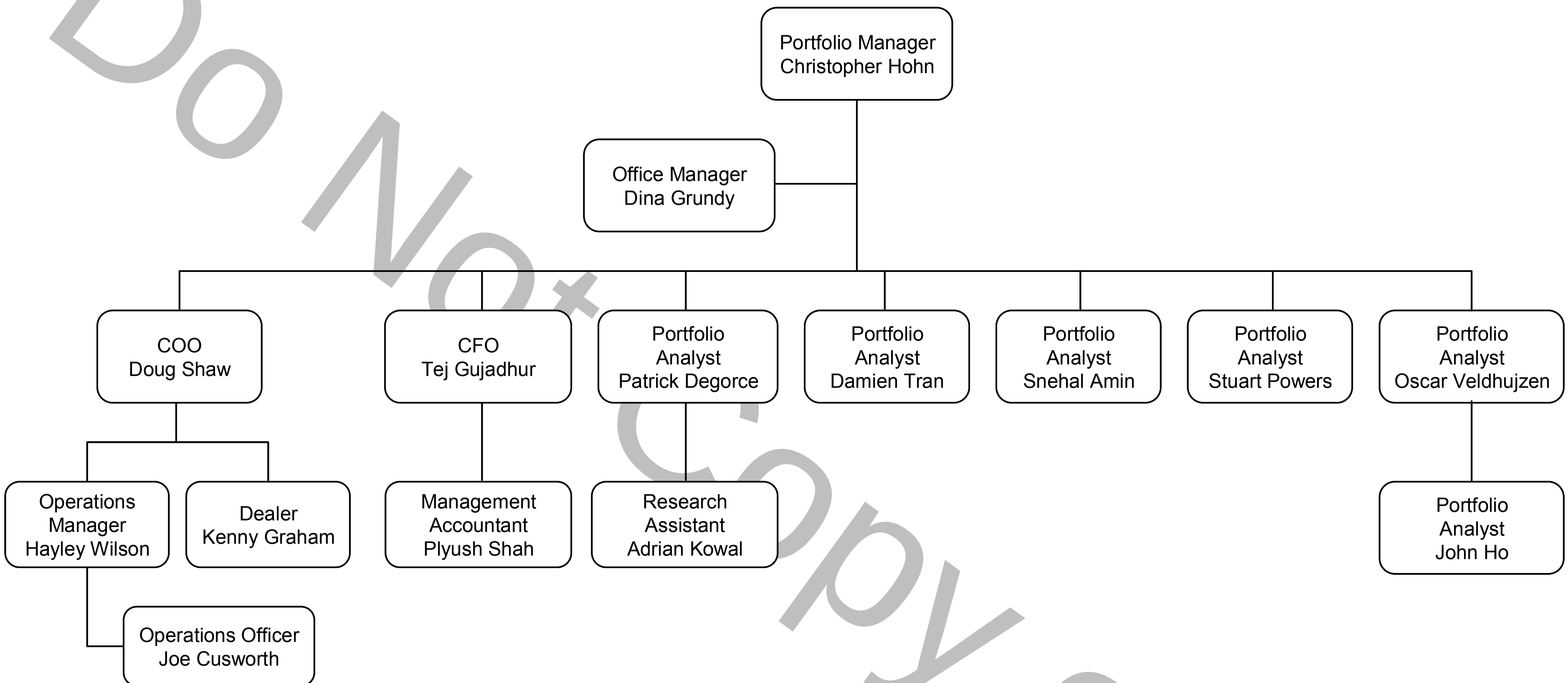
Exhibit 2b TCI Organization Chart



Source: The Children's Investment Fund.

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Exhibit 3 Deutsche Börse Segment Descriptions

Xetra and the Frankfurt Stock Exchange Beginning with the traditional Frankfurt Stock Exchange as its base, Deutsche Börse built a fully-electronic cash market for exchanging equities, debt, and other securities. The traditional Frankfurt Stock Exchange was a floor-based exchange, utilizing specialists or market makers to quote prices and arrange trades. In 1997, Deutsche Börse launched Xetra, a fully electronic trading platform that connected 283 of the largest banks and brokerages in Europe and the US. Xetra has been successful in supplementing and supplanting floor trading on the Frankfurt Stock Exchange, as well as taking trading volume from other exchanges.[23] In 2004, 98% of German equities trading occurred through Xetra.[24] Investors on Xetra were able to buy and sell foreign and domestic securities, exchange-traded-funds (ETFs), fixed-income securities, warrants, certificates, and other investment securities.

Investors buying and selling shares on Xetra enjoyed anonymity through settlement; Deutsche Börse assumed all counterparty default risk. Lastly, buying and selling orders were netted for each institution, reducing overall settlement costs. Xetra generated revenue through membership subscriptions paid by trading entities, as well as fees for the listing of securities, trading, settlement and clearing activities, with the majority of revenues coming from trading and clearing services.

Eurex In 1998, Deutsche Börse and the Swiss Exchange established an electronic trading and clearing platform for options, futures, and other derivative securities. By 2004, Eurex connected 400 participants in 18 countries. 1.1 billion contracts were traded through Eurex, making it the largest exchange of derivative securities, giving it global market share of around 55%.[25] Aside from operating an electronic trading platform, Eurex provided clearing and settlement. Eurex expanded its product mix to include over-the-counter (OTC) securities and expanded into the US with the launch of Eurex US, a Chicago-based electronic exchange of dollar-denominated interest rate derivative contracts.

Market Data & Analytics Segment Deutsche Börse's analytics segment collected information from Xetra, Eurex and other sources, compiled the data, and sold it to market participants. Customers included asset managers, traders, banks and other financial market participants. Deutsche Börse offered customers real-time price, volume and other information for all German and international equities, bonds, warrants, and ETFs, as well as back-office services. The business served as a compliment to Deutsche Börse's other businesses; while Xetra and Eurex revenues were driven by trading volume, most of the analytics segment revenues came from long-term, steady subscription contracts. The segment also maintained indices, such as DAX, the 30 leading stocks on the German stock exchange.

[23] Chacko and Dessain, *Deutsche Börse*, p. 9.

[24] Deutsche Börse, 2004 Annual Report (Deutsche Börse, 2004), p. 24, http://deutsche-boerse.com/dbag/dispatch/en/kir/gdb_navigation/investor_relations/30_Reports_and_Figures/30_Anual_Reports/10_Annual_Report_2004, accessed January 2006.

[25] Ibid., p. 34.

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Clearstream Segment Clearstream was the post-trade, settlement service for Deutsche Börse customers. Clearstream had been formed in 1999 from the assets of Deutsche Börse and Cedel, a settlement and custody house which performed cross-border bond exchanges dating back to the 1960s. In 2002, Deutsche Börse purchased 100% ownership of the business. Clearstream helped manage the complex post-trade settlement process involving multiple currencies and securities. At the conclusion of a trade, cash and securities were debited and credited for customer accounts. In addition, securities were held by Clearstream on behalf of customers, eliminating the need for the physical exchange of security certificates. Clearstream generated transaction related revenues for each trade settled, as well as spread interest (interest earned on customer deposits less interest paid to customers) and custody income (1-2 basis point fees for the safeguarding of securities). By the end of 2004, Clearstream held shares, bonds and funds valued at €8.7 trillion.

Clearstream allowed Deutsche Börse to provide "end-to-end" service for customers trading on Xetra, from price discovery, transaction execution and settlement.

Information Technology Segment Deutsche Börse sought to leverage additional revenue from its significant investment in IT systems (the two electronic exchanges Xetra and Eurex) by selling its IT services to other exchanges and its customers. In addition to being responsible for the ongoing operation of Deutsche Börse's systems, the IT business sold software components and services to outside parties. Market participants needed to be tightly integrated with Deutsche Börse's own systems, a process which the IT segment coordinated. Other exchanges also operated using Deutsche Börse's underlying software. For instance, the Shanghai Stock Exchange chose to build its own electronic exchange using Deutsche Börse's technology and IT services. In 2004, the IT segment had sales revenue of €125MM from external customers.[26] (See **Table 1** for earnings information.)

Table 1 Deutsche Börse EBIT and Margin by Segment

	2004 EBIT (€ millions)	2004 EBIT Margin (%)	2003 EBIT (€ millions)	2003 EBIT Margin (%)
Deutsche Börse Group	458.7	32	452.6	32
Xetra	86.2	40	57.6	27
Eurex	174.9	43	228.0	56
Market Data and Analytics	44.4	36	45.2	37
Clearstream	116.7	20	111.2	20
Information Technology	82.4	18	72.6	15

Source: Deutsche Börse 2004 Annual Report.

[26] Ibid., p. 54.

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Exhibit 4a Deutsche Börse Consolidated Income Statement

For year ending Dec 31 (€Millions)	**2003**	**2004**
Sales revenue	1,419.4	1,449.6
Net interest income from banking business	94.4	77.1
Own expenses capitalized	55.3	44.8
Other operating income	80.6	64.2
Total revenue	**1,649.7**	**1,635.7**
Fee and commission expenses from banking business	(117.0)	(118.5)
Consumables used	(35.4)	(33.6)
Staff costs	(317.7)	(335.7)
Depreciation and amortization expense	(198.0)	(191.0)
Other operating expenses	(453.3)	(431.3)
Result from equity investments	(0.5)	2.0
Goodwill amortization	(75.2)	(68.9)
Earnings before interest and taxes (EBIT)	**452.6**	**458.7**
Net financial result	(4.5)	(6.7)
Income tax expense	(202.5)	(197.8)
Net profit for the year	**245.6**	**254.2**
Minority interests	0.7	11.9
Net income	**246.3**	**266.1**
Earnings per share (basic and diluted) (€)	**2.20**	**2.38**

Source: Deutsche Börse 2004 Annual Report.

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Exhibit 4b Deutsche Börse Consolidated Balance Sheet

For year ending December 31 (€Millions)	2003	2004
Intangible assets		
Software	351.6	254.9
Goodwill	1,173.4	1,104.5
Payments on account and construction in progress	11.1	21.1
Other intangible assets	0.0	3.1
	1,536.1	**1,383.6**
Property, plant and equipment		
Land and buildings	132.5	124.7
Leasehold improvements	71.5	64.8
Computer hardware, operating and office equipment	69.9	56.1
Payments on account and construction in progress	54.7	0.0
	328.6	**245.6**
Financial assets and investment property		
Investments in associates	10.6	19.6
Other equity investments	26.1	14.2
Securities from banking business	384.5	355.2
Other financial instruments	9.5	10.1
Other loans	0.8	0.8
Investment property	54.0	114.7
	485.5	**514.6**
Total noncurrent assets	**2,350.2**	**2,143.8**
Miscellaneous and deferred tax assets		
Deferred tax assets	3.4	1.2
Other noncurrent assets	15.3	17.7
	18.7	**18.9**
Total noncurrent assets	**2,368.9**	**2,162.7**
Current Assets		
Receivable and other assets		
Current receivables and securities from banking business	4,047.3	4,583.4
Trade receivables	148.7	155.0
Associate receivables	2.3	0.0
Receivable s from other investors	4.7	2.9
Income tax receivables	6.8	10.9
Other current assets	100.8	80.3
	4,310.6	**4,832.5**
Restricted bank balances	1,048.4	867.4
Other cash and bank balances	548.1	740.2
Total current assets	**5,907.1**	**6,440.1**
Total assets	**8,276.0**	**8,602.8**

For year ending December 31 (€Millions)	2003	2004
Equity		
Subscribed capital	111.8	111.8
Share premium	1,330.2	1,330.2
Legal reserve and other retained earnings	760.2	868.5
Revaluation surplus	4.0	7.9
Unappropriated surplus	135.0	226.8
Shareholders' equity	**2,341.2**	**2,545.2**
Minority interest	12.3	7.3
Total equity	**2,353.5**	**2,552.5**
Provisions		
Noncurrent provisions		
Provisions for pensions and other employee benefits	68.4	79.0
Deferred tax liabilities	79.4	63.2
Other noncurrent provisions	40.2	51.7
	188.0	**193.9**
Current provisions		
Tax provisions	162.2	72.0
Other current provisions	36.2	39.6
	198.4	**111.6**
Total provisions	**386.4**	**305.5**
Liabilities		
Noncurrent liabilities		
Interest-bearing liabilities	503.2	502.3
Other noncurrent liabilities	7.1	10.4
	510.3	**512.7**
Current liabilities		
Liabilities from banking business	3,899.9	4,186.5
Other bank loans and overdrafts	5.0	0.0
Trade payables	108.2	79.0
Payables to associates	0.9	1.3
Payables to other investors	4.5	4.0
Cash deposits by market participants	901.1	831.5
Other current liabilities	106.2	129.8
	5,025.8	**5,232.1**
Total liabilities	**5,536.1**	**5,744.8**
Total provisions and liabilities	**5,922.5**	**6,050.3**
Total equity and liabilities	**8,276.0**	**8,602.8**

Source: Deutsche Börse 2004 Annual Report.

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Exhibit 4c Deutsche Börse Consolidated Statement of Cash Flows

For year ending Dec 31 (€ Millions)	2004	2003
Net profit for the year	254.2	245.6
Depreciation and amortization expense	259.9	273.2
Increase in noncurrent provisions	22.1	6.4
Deferred tax income	(13.8)	(3.8)
Other non-cash (income)/expense	(0.7)	1.1
Changes in working capital, net of non-cash items:		
Decrease/(increase) in receivables and other assets	13.3	(22.0)
(Decrease)/increase in current provisions	(88.0)	45.7
Decrease in noncurrent liabilities	(0.5)	(0.6)
Decrease in current liabilities	(6.4)	(15.4)
Net (profit)/loss on disposal of property, plant and equipment	(0.5)	0.4
Cash flows from operating activities	**439.6**	**530.6**
Payments to acquire noncurrent assets (excluding financial instruments)	(79.8)	(176.9)
Payments to acquire noncurrent financial instruments	(10.0)	(63.9)
Net increase in current receivables, securities and liabilities from banking business with an original term greater than three months	(31.4)	(431.7)
Proceeds from net disposals of available-for-sale noncurrent financial instruments	84.9	260.1
Proceeds from disposal of other noncurrent assets	2.8	0.0
Cash flows from investing activities	**(33.5)**	**(412.4)**
Net cash paid to minority shareholders	0.0	(9.7)
Net repayment of short-term financing	0.0	(293.1)
Finance lease payments	(2.0)	(2.8)
Repayment of long-term borrowings	(1.4)	(3.6)
Proceeds from long-term financing	0.0	497.5
Dividends paid	(61.4)	(49.2)
Cash flows from financing activities	**(64.8)**	**139.1**
Net change in cash and cash equivalents	341.3	257.3
Cash and cash equivalents at beginning of period	362.1	104.8
Cash and cash equivalents as at end of period	**703.4**	**362.1**

Source: Deutsche Börse 2004 Annual Report.

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Exhibit 5 Deutsche Börse Shareholders by Country

	Ownership of Deutsche Börse by Country (%)		
	December 2001	December 2004	April 2005
Germany	68	35	7
Britain	12	24	48
United States	12	26	29
Other	8	15	16

Source: "Deutsche Börse," The Economist, May 14, 2005, pp. 79–80.

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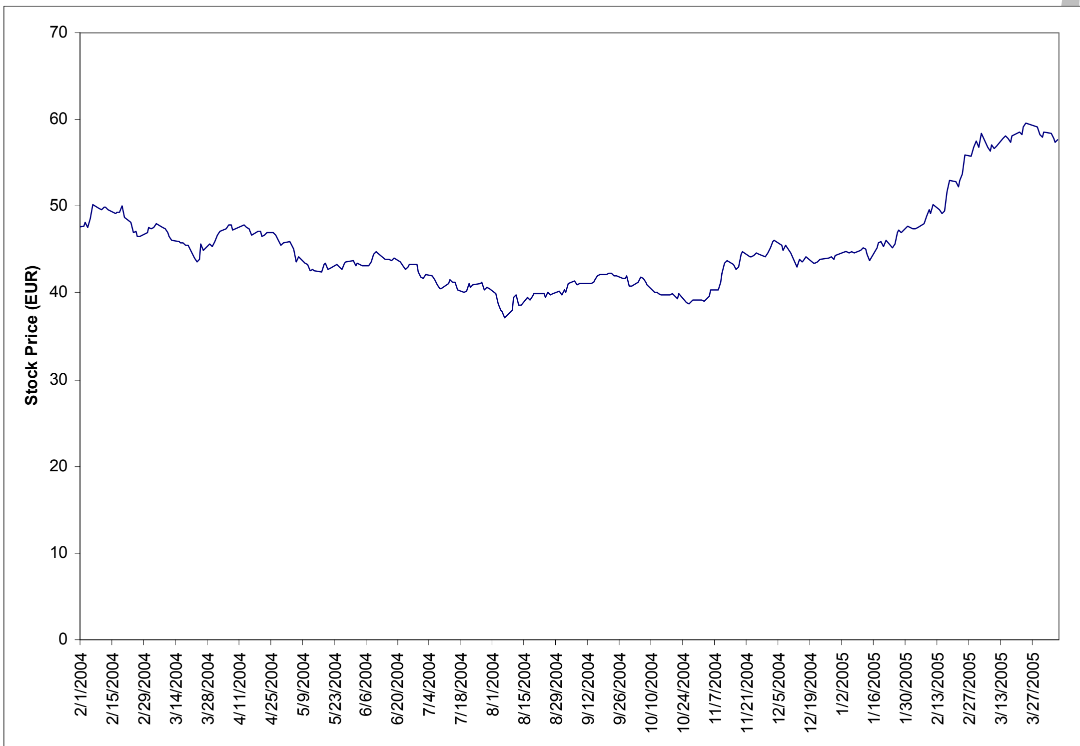
Exhibit 6 Annotated Deutsche Börse Stock Price Graph



Timeline:

August 2004:	TCI accumulates 1.8 million shares of Deutsche Börse.
November 2004:	Rumors circulate of possible merger between LSE and Deutsche Börse.
December 13, 2004:	Deutsche Börse announces intention to acquire LSE for 530p.
January 14, 2005:	TCI announces intent to lead vote to remove Deutsche Börse Supervisory Board.
January 17, 2005:	Deutsche Börse Supervisory Board grants preliminary approval for offer for LSE.
March 6, 2005:	Deutsche Börse announces abandonment for LSE bid.
April 7, 2005:	Deutsche Börse announces Shareholder Value Enhancement Program.

Source: Bloomberg data, accessed January 2006.

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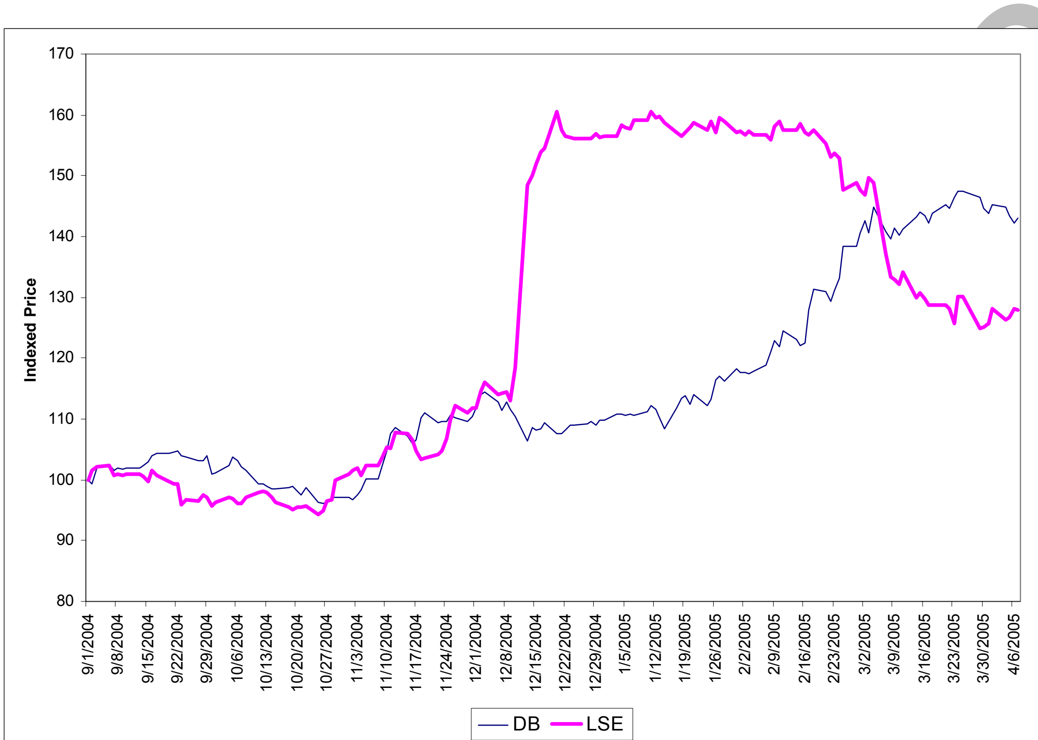
Exhibit 7 Indexed Deutsche Börse and London Stock Exchange Stock Price Graph



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