PAKISTAN SHOWCASES GROWING PAINS OF AN EMERGING MARKET

By Usman Hayat

The key issues facing Pakistan's equity market, such as a small investor base, few new listings at the Pakistan Stock Exchange (PSX), and shrinking turnover are tied to the lack of trust by investors and issuers and unnecessary compliance and tax burden. It will take greater professionalism by the intermediaries and rationalization of regulation and taxation by the regulators and the tax authorities to realize the market potential.

This was the central message that came out of Pakistan Inc, a conference organized by the CFA Society of Pakistan on its 15th anniversary in Karachi on 24 November 2017. The conference brought together some of the best minds from Pakistan ranging from investment managers, business leaders, regulators, and legal and accounting professionals to debate the issues facing the capital market. Around 250 delegates, most of them financial services professionals, attended and more joined online.

Ashraf Bava, CFA, President of CFA Society Pakistan, highlighting the issues facing the market and the need to resolve them

TOO FEW INVESTORS CHASING TOO FEW STOCKS

A market cap of around USD 85 billion, which is less than 30 percent of Pakistan GDP of about $300 billion, means the market is too small to serve the country's saving and retirement needs and attract large foreign investors.

Few companies choose to list on the exchange. In fact, the number of listed entities has reduced over the years. There were more than 700 listed entities in the early 2000s, which has dropped own to less than 580. Within the listed companies, there are many that are illiquid or no longer operational. In 2017, there were only seven new listings despite a stunning bull run in 2016.
The benefits of listing are seen to be outweighed by its ongoing costs. In a live digital poll of the audience, the majority (63 percent) voted that the most important reason keeping companies away from listing is the regulatory and compliance burden. When a company seeks advice on listing, "my advice is do not list", said a prominent accounting professional.

The investor base is small. Even a liberal estimate would suggest that the number of investors is not more than a half a million, which is tiny compared to Pakistan's growing middles class and its 207.77 million population. Market also remains highly concentrated: 5000 investors account for 90 percent of trading which is confined to just about 30 stocks.

Panel discussing Pakistan's economy and why there are so few listings at PSX

TURNOVER IS SHRINKING, SO ARE THE BROKERS

In the early 2000s, the turnover velocity on the main board used to be up to 300 percent. Now it has dropped to around 30 percent. In international exchanges, much of the trading has moved from the cash segment to the derivatives segments but the same has not happened at PSX. The struggle to replace the traditional badla financing, a unique form of repo financing, with derivatives has met with little success.

The number of stock brokers, currently at about 225, is decreasing every month. Commissions have been falling and costs increasing.

Some of the largest brokers are more like large investors, financiers, and business groups rather than an intermediary. The Chinese walls among their businesses (brokerage, asset management, real sector companies etc) are not known for their thickness and their financial incentives do not necessarily favor market development. Add to it that the stock market has faced major crises in 2000, 2002, 2005, and 2008. There is a widely held perception that market is subject to manipulation and investors are vulnerable to abuse.

REGAINING EMERGING MARKET STATUS HAS BEEN BITTER SWEET

In 2016, there was jubilation in Pakistan's stock market when the MSCI announced that Pakistan shall regain its status as an emerging market, which it had lost in 2008. Foreign investors are estimated to be holding a quarter of the market free float and expectation of large inflows by funds tracking the MSCI emerging market index took the KSE-100 index to its highest ever level of 53,015 points. The jubilation soon gave away to pensive reflection. Contrary to expectations, the market had experienced more outflows than inflows because of reasons such as a low eventual weight of Pakistan in the MSCI emerging market index.

POLITICAL UNCERTAINTY WEIGHING HEAVY ON THE MARKET

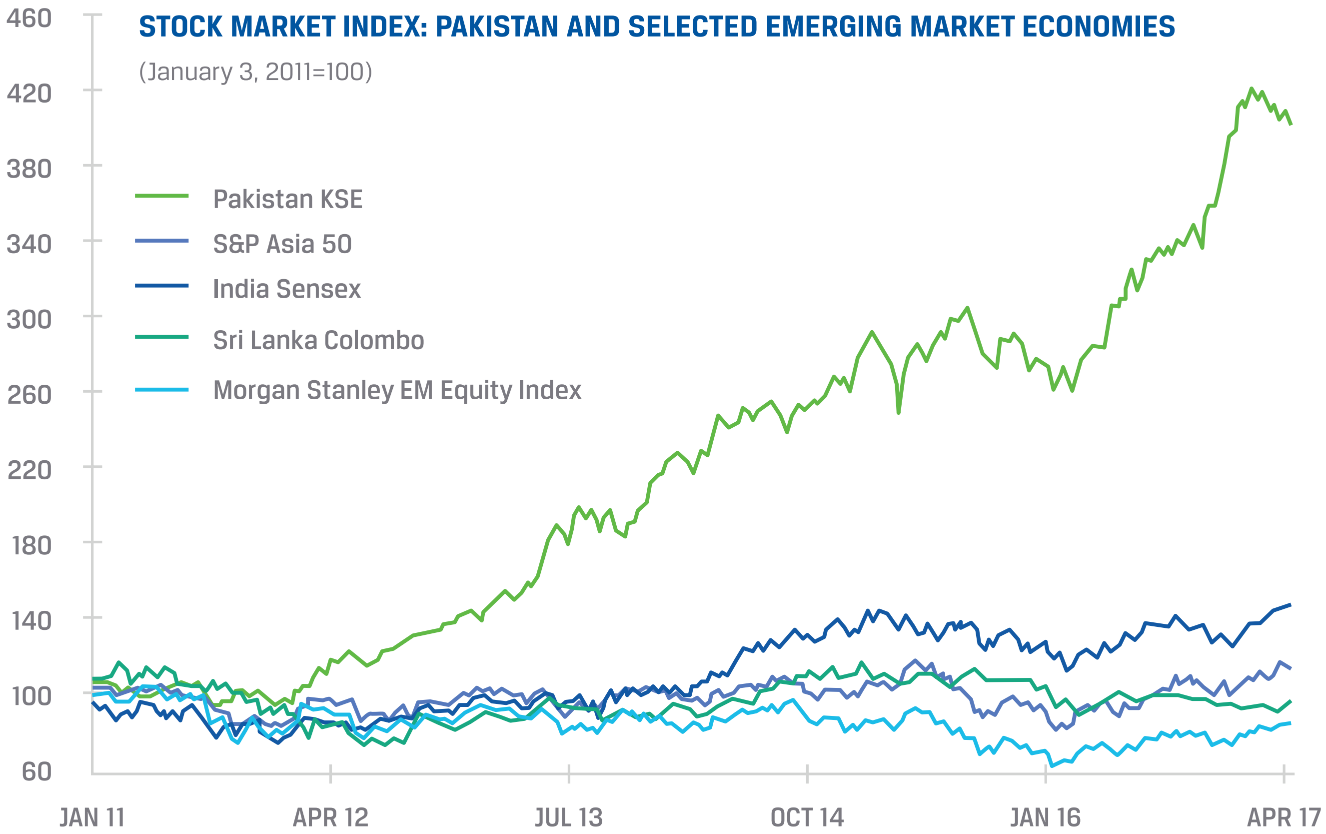
A political turmoil in Pakistan has seen the prime minister getting disqualified by the apex court and the finance minister facing an ongoing trial. The writ of the government has been greatly weakened. A record high trade deficit and widening fiscal deficit are putting pressure on the Pakistani Rupees, which, as per estimates by IMF, is overvalued by 20 percent. As the economic challenges mount, the strong economic leadership needed to steer the country is conspicuous by its absence.

After rising 46 percent in 2016, the KSE-100 index has retreated 25 percent from its all-time high hit in 2017. The market price to earnings ratio has slid down to about 9x but value investors are still not finding the market attractive enough.

TAXATION AND COMPLIANCE CHOKING THE MARKET

Tax authorities have been increasing the tax burden on the capital market. Higher taxes on capital gains and dividends together with presumptive tax on trading are choking the market. While capital market is subject to extensive documentation and taxation, the ever popular real estate investing is not, making it very hard to attract investors.

There are so many different conditions, restrictions, periodic reports, audits, inspections, and investigations by the securities regulator that companies and intermediaries are finding it hard to keep up. In a live poll, majority of the audience (59 percent) voted that the capital market is over-regulated. Despite the plethora of new regulations, the market perception and investor confidence have shown little improvement. "What we need is effective regulation, not more regulation", said a former chairperson of the Competition Commission of Pakistan, summing up the sentiment in the hall.



Pakistan's stock market has been offering stellar returns beating the regional markets - graph by IMF

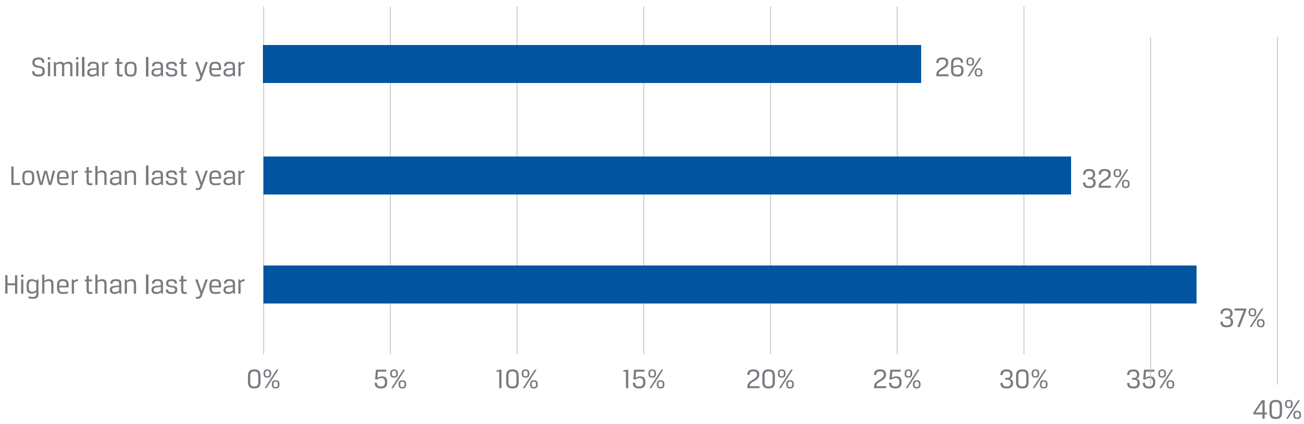
THERE HAS BEEN PROGRESS, THERE ARE SOLUTIONS

Speaking at the event, Paul Smith, CFA, President of CFA Institute, explained that the problems facing Pakistan's capital market are not unique and its internal security situation is much better than perceived internationally.

You Hang, who has recently taken up the role of deputy managing director of PSX, highlighted that progress has been made in developing the market infrastructure. Pakistan's three stock exchanges have been merged to form the PSX, which has successfully demutualized and self-listed with a consortium of Chinese exchanges – some of the largest exchanges in the world – taking up a strategic equity stake.

Those present in the audience were not without hope. Responding to a live poll, 37 percent voted that they expect the GDP growth rate for the current fiscal year to be higher than that of the last fiscal year.

LIVE AUDIENCE POLL: WHAT ARE YOUR EXPECTATIONS REGARDING GDP GROWTH RATE FOR THE CURRENT FISCAL YEAR?



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Investment managers pointed out that there has been strong growth in the mutual fund industry where large domestic inflows have reduced the negative effect of net selling by foreign investors. Market is currently bearish but it has been offering superior performance than most regional markets.

The potential is large. A rising middle class, facilitated by low inflation and bank credit, is making its presence felt through record consumption. For example, annual growth in auto sales and auto loans is approaching as high as 30 percent.

The Government has taken bold steps to control the security and law and order situation. The street crime plaguing the commercial hub of Karachi has substantially decreased. The improving energy situation and reducing power outages coupled with a young population and mega projects under the China Pakistan Economic Corridor are likely to fuel the economic growth.

Panel discussing the future outlook for the capital market

THE WAY FORWARD: RATIONALIZATION AND PROFESSIONALISM

After a full day of impassioned and candid discussions on the capital market issues among some of the most prominent professionals in Pakistan, three solutions within the reach of market participants, securities regulator, and tax authorities stood out. The tax authorities need to reduce the tax burden and the SECP needs to rationalize the compliance burden dragging the development of the market. At the same time, practitioners must also aspire to higher standards for professionalism and put the interest of the clients above their own. That's what builds the trust in the market and it is this trust that is foundation for sustainable growth.