8 Capital Markets

8.1 Overview

The first quarter of FY04 witnessed an acceleration in the extended market rally (that took the KSE-100 to a new all-time high before suffering a large correction), a rise in speculative equity investments (see **Figure 8.1**), and a slowdown in issuance of listed corporate debt.

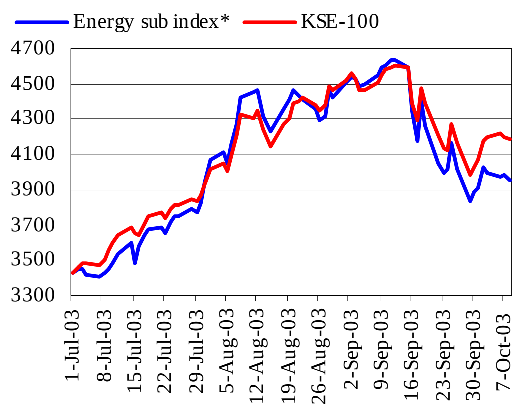
Of these, the developments in the equity market were arguably the most significant. In particular, the KSE-100 gained momentum until mid-September 2003 amidst considerable liquidity and sustained investor interest in energy stocks. The leading contribution of the energy stocks in the rally, under the lead of scrips such as Pakistan Oil Fields (amid expectations of an exceptional result announcement), PSO (with hopes of early progress towards its privatization) and Hubco, is evident in **Figure 8.2**.[1]

The index rapidly pushed past the 3500, 4000 and 4500 psychological barriers to peak

Table 8.1: Key Indicators of Stock Market (KSE) during Q1
Rupees and Stocks in billions

Indicators	FY03	FY04
Price indices		
KSE-100 index	2018.8	4027.3
Change in KSE-100 index	14.0	18.4
SBP General index of share prices	113.8	223.2
Change in SBP General index	6.6	8.9
Market size		
Market capitalization	458.3	876.1
Market capitalization (as % of GDP)	12.6	21.8
No. of listed companies	723	700
Market liquidity		
Value traded	333.5	1738.6
Total turnover of shares traded	7.2	32.0
Value traded (as % of GDP)	9.2	47.9
Turnover ratio	0.7	2.0
Average daily value traded	5.1	26.7
Average daily turnover of shares	0.11	0.5
Paid-up capital at KSE	275.0	305.0

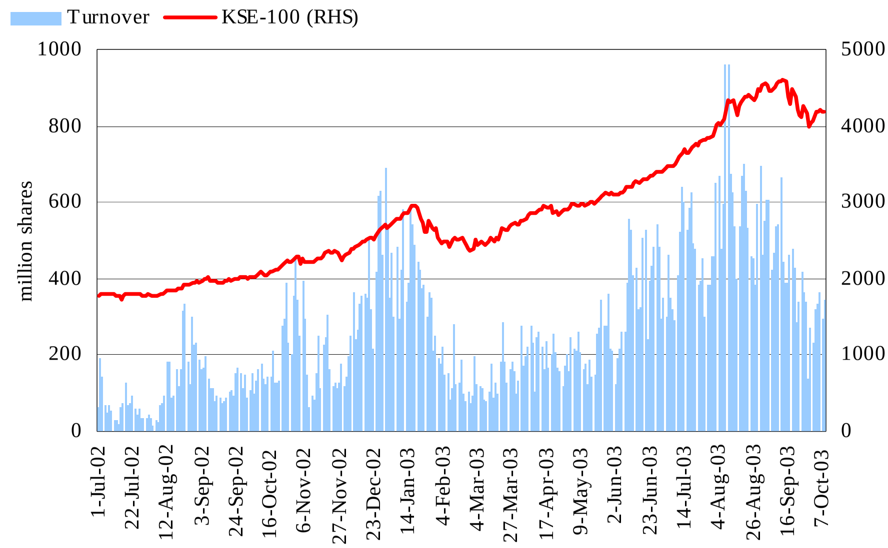
Figure 8.2: Energy Sector vs KSE-100 Index



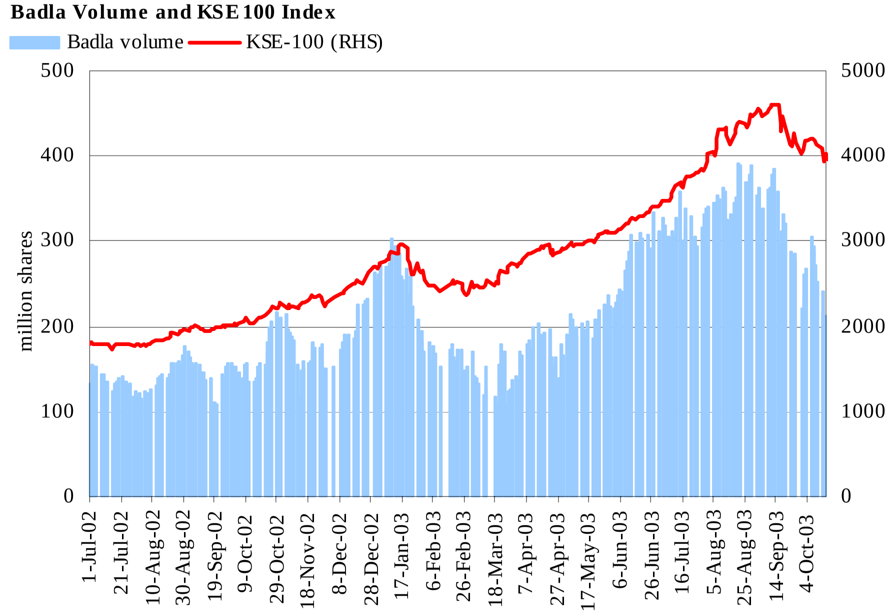
*The Energy Index is calculated by taking market capitalization of energy sector for July 1, 2003 as base (3432 points), and tracking the relative changes in the market capitalization of energy stocks afterwards.

[1] Energy stocks capitalization is more than 24 percent of the total market capitalization of the KSE-100 at end-September 2003.

Figure 8.1: KSE-100 Index and Turnover



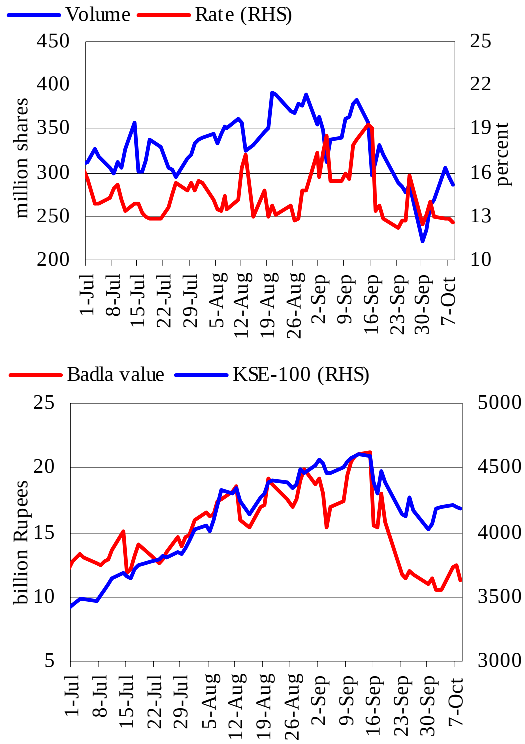
Badla Volume and KSE 100 Index



at a new all-time high of 4606 points by September 12, 2003 (a 35 percent increase since June 30, 2003). This performance of the market is also reflected in market size as well as liquidity indicators (see **Table 8.1**).

Importantly, part of the reason for the market's rise was on the surge in speculative investments (see **Figure 8.3**). The average daily badla volumes rose to 331.3 million shares during Q1-FY04, more than twice the 139.1 million shares figure for the same period last year; similarly, the average daily badla value witnessed a very substantial increase of Rs 11.7 billion. Not surprisingly therefore, despite a drop in interest rates, the average badla rate of 14.6 percent during Q1-FY04 was higher than the 9.9 percent in the comparable quarter of FY03 and 8.9 percent in the immediately preceding quarter.

Figure 8.3: Badla Transactions during Q1-FY04



The Q1-FY04 market rally was therefore increasingly vulnerable, particularly to adverse developments in the COT (badla market). In fact, this vulnerability played an important role in the significant market correction witnessed during the later half of September 2003. More specifically, the lack of substantial progress towards the privatization of PSO soured investor sentiment, compounded by a trend reversal in interest rates that contributed (together with high badla volumes), to an increase in the badla financing rates. [2]

[2] Significantly, badla rates peaked at over 19 percent by mid-September 2003, as the market corrected.

As a result, the KSE-100 index fell from its 4606 point peak to close the quarter at 4027.3 points. Nonetheless, despite the correction, on aggregate the KSE-100 witnessed an 18.4 percent increase from the end-June 2003 level that raised the market capitalization of the Karachi Stock Exchange to Rs 876.1 billion.[3]

8.2 Sector-wise Performance of KSE

As in the preceding quarter, investor interest was most evident in the *fuel & energy* sector of the KSE, which comprises almost one-fourth of the total market capitalization, as evident in the sector's dominant share in total traded value. As a result, energy stocks have by far the best turnover ratios amongst the KSE sectors (see **Table 8.2**).

Table 8.2: Sector Wise Performance of KSE

Sectors	Mkt. cap. billion Rs*	Share in Mkt. cap. (%)	Traded value billion Rs **	Traded value (%)	Turnover ratio
Fuel & energy	218.4	24.6	1086.0	62.5	4.97
Transport & communication	160.8	18.1	196.9	11.3	1.22
Chemical & pharmaceuticals	123.2	13.9	139.8	8.0	1.14
Investment companies & banks	90.7	10.2	89.3	5.1	0.99
Food & allied	40.1	4.5	0.2	0.0	0.01
Cement	38.3	4.3	115.8	6.7	3.02
Auto & allied	33.9	3.8	19.4	1.1	0.57
Textile composite	22.7	2.6	26.6	1.5	1.17
Synthetic & rayon	24.2	2.7	21.8	1.3	0.90
Insurance	21.2	2.4	18.0	1.0	0.85

* Market capitalization as on September 30, 2003
** For the whole quarter

The other better performing sectors during Q1-FY04 were the *transport & communication*, followed by *chemical & pharmaceutical* that recorded 30.9 percent and 14.9 percent increases in market capitalization respectively. The performance of the cement sector is also notable; not only did the market capitalization increase 17 percent during the quarter, the turnover ratio was also quite high.

8.3 Corporate Bond Market

The outstanding stock of listed corporate debt totaled Rs 29.5 billion at end-September 2003, as only two listed issues, totaling Rs 1.3 billion, were offered

[3] The YoY increase is a massive Rs 417.8 billion (from Rs 458.3 billion by end-June 2003 to Rs 876.1 billion by end-September 2003). Moreover, the gain in US Dollar terms is even stronger due to the rupee appreciation witnessed since end-Q1-FY03.

during the Q1-FY04. This low issuance compares poorly with Q1-FY03 (see **Table 8.3**), which, in turn, probably reflects the impact of the aggressive lending policies adopted by commercial banks. However issuance could pick up again in view of the recent up trend in long-term interest rates.

Table 8.3: Corporate Debt Profile during Q1

Amount in billion Rupees

	No. of issues	Amount
FY02	2	1.7
FY03	9	4.8
FY04	2	1.3
Total outstanding*	56	29.5

*End-September 2003

The latter will also affect the prospects of floating rate TFCs incorporating a call option. Out of total 55 outstanding issues 18 TFCs incorporate this option, and due to the presence of interest rate floor, all are currently paying high coupons that are in excess of the corresponding market-based levels, i.e., the floating rates that would have been applicable in the absence of the floor (see **Table 8.4**).[4]

Table 8.4: TFCs with Call Option*

Issuer	Tenor	Issue date	Floor	Without floor	
				Rate	> floor
Engro Asahi Polymer & Chemicals Ltd.	5 Years	15-Jun-01	13.0	5.5	-7.5
Packages Limited	4 Years	30-Aug-01	13.5	8.7	-4.9
Engro Chemicals Pakistan Limited (1st tranche)	5 Years	27-Nov-01	13.0	8.7	-4.4
Crescent Leasing Corp. Ltd. (1st tranche)	5 Years	27-Dec-01	14.5	6.3	-8.2
Security Leasing Corporation	4 Years	29-Dec-01	14.8	10.0	-4.8
Saudi Pak Leasing Co. Ltd. (2nd tranche)	5 Years	1-Jun-02	12.0	6.0	-6.0
Engro Chemicals Pakistan Ltd. (2nd tranche)	5 Years	5-Jul-02	11.0	5.3	-5.7
Crescent Leasing Corp. Ltd. 2nd Issue	5 Years	5-Sep-02	12.0	6.3	-5.7
Quetta Textile Mills Ltd.	5Years	26-Oct-02	13.0	10.0	-3.0
Security Leasing Corporation Ltd. (2nd Issue)	4 Years	9-Jan-03	11.0	9.8	-1.3
KASB Leasing Ltd.	5 Years	15-Jan-03	11.5	6.6	-4.9
Gulistan Textile Mills Ltd. (2nd Issue)	5 Years	30-Jan-03	11.0	9.8	-1.3
Paramount Spinning Mills Ltd.	5 Years	30-Jan-03	10.9	9.5	-1.4
Gulshan Spinning Mills Ltd.	5 Years	30-Jan-03	11.0	9.8	-1.3
Paramount Leasing Ltd. (2nd Issue)	4 Years	7-Feb-03	11.5	10.0	-1.5
Jahangir Siddiqui & Co. Ltd.	5 Years	18-Apr-03	7.5	5.8	-1.7
Trust Leasing Corp. Ltd.	5 Years	3-Jun-03	9.0	9.5	0.5
Ittehad Chemical	5 Years	27-Jun-03	7.0	10.0	3.0

* Assuming these TFCs have been reset using the most recent base rates at September 30, 2003

[4] For the purposes on this comparison it is assumed that the absence of the floor would not have materially affected the coupon structure.

Clearly, if the market expects long-term interest rates to rise, it is likely that the TFCs with relatively short remaining maturity and current coupons close to the corresponding floor may not be called.

8.4 Open-end Mutual Funds

Mutual funds provide an attractive, cost-effective alternative to direct purchases of stocks or bonds for investors, particularly small investors. The major advantages offered by mutual funds are:

1. Economies of scale in management cost. The cost of hiring professional manager as well as accessing variety of resources to research, analyze financial data, interpret economic and market trends and help make sound investment decisions, is spread over a large pool of money, reducing per unit cost.

2. Mutual fund's assets are typically invested in a diversified portfolio of securities. This strategy helps reduce risk and provide more consistent return potential over the long term,

3. Open-end mutual funds calculate the price of share every business day and provides greater liquidity to the investors who can buy or sell on the quoted prices,[5] and

4. Government provides safety nets to the investors by regulating the mutual fund business.

In Pakistan 'National Investment (Unit) Trust' started as the first open-end mutual funds in 1962. The company enjoyed monopoly power till mid-1990s, as the private sector was not allowed to enter this business. The financial sector reforms, initiated in early 1990s, encouraged the private sector to undertake asset management business.

However, initially there was scant private sector interest in setting up open-end mutual funds, and until 2002 there was only one private sector fund competing with the public sector NIT. However, encouraged by low rupee interest rates (particularly on the long bonds) and strong performance of the local equity

[5] Open-end funds are required to establish a daily price for shares, called the net asset value, or NAV. A mutual fund share is calculated based on the fund's net asset values (NAV). Fund NAVs are calculated at the end of each business day by adding up the total value of the fund's investments in stocks and the like and dividing it by the number of fund shares outstanding.

markets, there was a significant shift in the industry. Specifically, seven out of nine open-end mutual funds operating as of end-September 2003 were established during the preceding two years. Of these, five were income funds, one was an equity market fund and another was an Islamic fund (see **Table 8.5**).[6]

Table 8.5: Open-End Mutual Funds Profile
billion Rupees

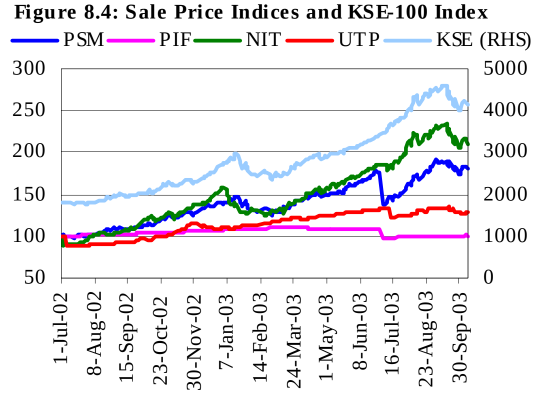
Fund	Nature	Established
NIT	Stock Market Fund	1962
UTP	Balanced Fund	Oct 01, 1997
PSM	Stock Market Fund	Mar 12, 2002
PIF	Income Fund	Mar 12, 2002
UTPIF	Income Fund	Aug 25, 2002
UMMF	Income Fund	Nov 01, 2002
MMF	Income Fund	Nov 01, 2002
UTPIS	Islamic Fund	Dec 27, 2002
DMMF	Income Fund	May 20, 2003

The net assets of the open-end mutual funds witnessed an impressive increase of Rs 20.8 billion during FY03. It is worth noting however, that the bulk of this increase is due to a combination of an exceptionally strong boom in the stock market as well as the capital gains on bond holdings (as interest rates declined). Specifically, the net assets, adjusted for the newly established funds, surged to Rs 35.6 billion by end-FY03 accounting for 80.0 percent of the total rise.

Table 8.6: Net Assets and Market Shares
billion Rupees

	Net Assets		Shares (%)	
Name	**FY02**	**FY03**	**FY02**	**FY03**
NIT	18.4	31.6	91.9	79.6
UTP	0.9	1.7	4.7	4.2
PSM	0.3	0.8	1.7	2
PIF	0.3	1.5	1.6	3.8
UTPIF	-	0.4	-	1
UMMF	-	2.2	-	5.5
MMF	-	0.5	-	1.3
UTPIS	-	0.5	-	1.1
DMMF	-	0.6	-	1.5
Total	18.9	39.7	100	100

Figure 8.4: Sale Price Indices and KSE-100 Index



The entry of new private sector fund also meant that despite a sharp gain in NAV, NIT (largest mutual fund) saw a fall of 12.3 percent in its market share. This change in market concentration is

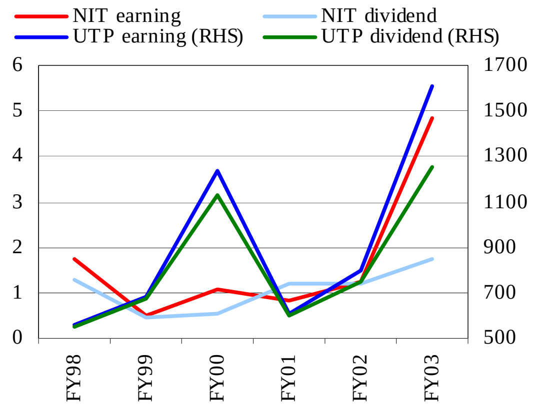
[6] While the income funds deal with fixed income securities, stock market funds investment in equities and the Islamic fund primarily business with Shariah Compliant instruments. The balanced funds can invest in both equities and fixed income securities.

likely to improve further in the future with the launch of new funds (see **Table 8.6**).

During Q1-FY04 open-end mutual funds have witnessed a substantial increase in NAVs, primarily reflecting the greater industry exposure to the equity market (**Figure 8.4**). In fact, funds mainly invested in the equity market (NIT, PSM) have clearly outperformed both, balanced fund (UTP), as well as fixed income funds.

Not surprisingly, the distributable income of mutual funds witnessed a substantial growth during FY03 (see **Figure 8.5**).[7] While the exceptional equity market performance was clearly the major contributor to these developments, mutual funds also gained significantly from their fixed income investments, as declining interest rates permitted spectacular capital gains.

Figure 8.5: Distributable Income/Dividend (Rs/unit)



[7] Only comparison for UTP and NIT is discussed, since the rest of the open-end mutual funds started business in or after second half of FY02, the data for income and dividend is not comparable for FY02 and FY03.