4 Capital Markets[59]

The salient feature of FY04 was sixteen Public Offerings amounting to Rs 55.6 billion. Such a large number of new issues and mobilization had not taken place for some years. Investor appetite was so strong that most of these issues were oversubscribed. The other positive outcome was strong growth in corporate earnings; average earning growth in FY04 was 26.5 percent. All these positive developments are captured in the momentum of the extended 2 year rally, which continued into FY04, with the benchmark index (the KSE-100) rising to a new all time high of 5620.6 in April 2004 before surrendering a fraction of its gains by end-June 2004. In annual terms, the KSE-100 Index, thus, registered a YoY growth of 54 percent in FY04 which is quite extraordinary given that it had already seen a 92.2 percent rise in FY03.

The impact of the extended market rally on the KSE market capitalization was augmented by the additional listings (particualrly of OGDC). Specifically, market capitalization of the KSE rose by an impressive 49.5 percent, increasing its share in GDP to over 26 percent from 19.7 percent at the end of the preceding year.[60] In fact, the new listed capital shows an addition of Rs 55.6 billion during FY04, which is far greater than Rs 13.8 billion added during the preceding three years.[61] Not surprisingly, given the increased market activity, market liquidity also improved during FY04, with the average daily trading volume jumping by 25.9 percent compared to that in FY03.

The increase in the KSE-100 Index was driven primarily due to improvements in economic fundamentals. The low prevailing interest rate continued to drive non-

[59] There are currently three stock exchanges in Pakistan. However, over the years the KSE has remained the pre-eminent capital market in the country, accounting for the majority of shares traded as well as most of the equity and debt listings. This was also the case in FY04. Therefore, the discussion on Pakistan's capital markets centers around the Karachi Stock Exchange (KSE).

[60] The capitalization to GDP ratio measures the extent of stock market penetration in an economy. The growth in corporate earnings provides the link between capitalization and GDP. Specifically, the market capitalization is correlated with stock prices, which are based on expected growth of corporate earnings. The corporate earnings in turn are linked with GDP and expected GDP growth rates. The ratio of market capitalization to GDP is also affected by the nature of financial structure and liquidity in the stock markets. A higher liquidity enables the investors to buy and sell securities easily. Thus, a liquid equity market makes investment less risky and more atractive thereby increasing the marekt capitalization.

[61] While the total number of listed companies fell during the year, number of new entrants in FY04 was 14 compared to 6 new companies during the preceding year.

bank corporate earnings both directly (by reducing financing costs) and indirectly (by spurring demand in the broader economy, and thus corporate profitability)[62, 63]. Similarly, low interest rates also added substantially to the profitability of banks, through increased credit offtake as well as capital gains on their long-term bond holdings.

An additional factor affecting the market sentiment was the public offerings of a number of government owned companies. The offer price was set at a discount to the assessed "fair price" value, probably as a part of the government strategy to increase the investor base.[64] The offerings attracted substantial investments, particularly as investors' interest was already whetted by the sustained rise in equity prices in the past months. The positive sentiment was reinforced by developments on the political front including the improvement in relations with India, recognition of Pakistan as Non-NATO ally by USA, resolution of Legal Framework Order (LFO) issue, etc.

However, the market could not maintain the upward momentum towards the end of the fiscal year, mainly due to deteriorating law & order situation in the country and the announcement of Capital Value Tax (CVT) in the Federal Budget for FY05. Consequently, the market volumes and turnover started falling from May 2004 onwards. Later in the month of September, the unexpected change in the transition plan aimed at replacing badla with margin financing (see **Section 4.9** for details) kept the market under tremendous selling pressure. However, the market recovered some of the losses following the encouraging results of some corporates.

The strong rise in the equity market, together with the continuation of the low returns on alternative investments naturally also spurred the development of the mutual funds industry; FY04 saw the addition of three new closed-end mutual funds, with total assets under management nearly doubling in FY04 to Rs 97.3 billion. The performance of corporate debt market, on the other hand, remained subdued, largely due to low interest rate environment. The market witnessed the issue of only six new listed debt instruments (valuing Rs 3.3 billion) during FY04 compared to 15 instruments (Rs 6.2 billion) in the preceding year (see **Table 4.1**).

[62] In fact, the earnings of the top 30 KSE companies (by market cap) rose by 22.4 percent YoY in FY04.
[63] Out of the 666 companies listed in the KSE, earnings of 265 companies were available that showed an impressive increase of 26.5 percent during FY04.
[64] Shares of these companies traded at premium in comparison to their offer price.

Table 4.1 Overview of Capital Markets

Equities (KSE)		**FY02**	**FY03**	**FY04**	**30 Sept 04**
Listed companies	numbers	711	701	666	663
Listed capital	billion Rupees	291	313	377	390.4
Market capitalization	billion Rupees	595	951	1421.5	1489.2
Market capt. as % of GDP	percentage	13.5	19.7	26.0	26.1
New listed companies	numbers	4	6	12	2
New listed capital	billion Rupees	6.3	4.6	55.6	20.8
Debt instruments (all listed)					
New debt instruments listed	numbers	17	22	6	3
Amount	billion Rupees.	10.1	10.6	3.3	3.7
KSE-100 index					
High		2701.4	4606	5620.66	5485.7
Low		1322.1	2356.5	3430.8	5289.9
Turnover (KSE)					
Average volume per day (shares)	billion	0.17	0.31	0.39	0.24
Total traded value	billion Rupees	805	2270	4925	770
Lahore stock exchange					
LSE-25 Index		296.9	2034.5	2828.3	2685.5
LSE market capitalization	billion Rupees	384.3	684.8	1315.9	1396.1
Islamabad stock exchange					
ISE-25 index		4683.9	8210.1	11894.3	1570.6
ISE market capitalization	billion Rupees	301.3	541.3	1106.2	1159.5

4.1 International Comparison

The performance of the Karachi equity market was also fairly remarkable in comparison with global equity markets, as shown in **Figure 4.1.** However, it should be noted that this comparison is based on Morgan Stanley Composite Index, which is a free-float weighted equity index of the world stock markets,[65] and is only indicative of the performance of the KSE-100.

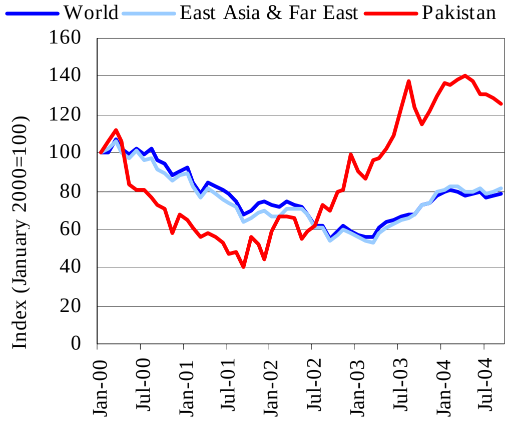
It may be pointed out that the fall in world stock markets after CY00 was mainly attributable to the collapse of the information technology bubble. However, the simultaneous decline in the equity market in Pakistan is unrelated with this trend.

[65] The free-float index takes into account only those shares, which are available for trading in the stock market, i.e., available for purchase in the market.

An international comparison of the market capitalization to GDP ratio, however, shows that while Pakistan's ratio has steadily increased in recent years, it remains significantly lower than for other countries in the sample (see **Table 4.2**). It is also interesting to note the sharp contrast between Pakistan's capitalization ratio (which is low) and the turnover ratio (which is one of the highest in the world). This characteristic, which Pakistan shares with India, probably reflects the large speculative element in these markets, which is aided by the availability of badla financing.

The **Table 4.2** shows the traded value as percent of market capitalization, reflecting the trading activity in the stock market. Countries like Argentina that were hit by financial crisis and political unrest witnessed very low traded value as percentage of capitalization. Pakistan, on the other hand, experienced a decreasing trend of traded value from 251.9 percent of capitalization in CY02, to 40.1 percent in CY03 which probably owes significantly to the sharp rise of the KSE-100 as well as the listing of large government-owned companies.

Figure 4.1: KSE vs Global Markets (based on MSCI)



Source: Bloomberg

Table 4.2: Capitalization to GDP Ratio of Selected Countries
percent

	Capitalization ratio		Turnover ratio	
	CY02	CY03	CY02	CY03
Argentina	100.9	31.3	2.2	1.7
Australia	93.1	90.2	64.3	77.2
China	36.6	37.6	85.7	11.5
Hong Kong	286.7	271.4	38.8	43.5
India	25.7	46.6	225.8	14.1
Japan	53.2	50.5	1.6	71.0
Malaysia	130.7	171.8	17.5	3.3
Pakistan	**17.3**	**23.8**	**251.9**	**40.1**
Philippines	50.0	31.1	14.8	0.9
Singapore	117.2	111.6	54.0	39.3
South Africa	177.5	155.6	78.9	3.6
Sri Lanka	10.1	15.6	11.5	1.2
Thailand	36.3	57.1	98.3	18.2
Turkey	18.5	16.9	163.4	28.5
USA	106.4	110.4	210.3	202.5
UK	119.0	117.2	84.4	135.4

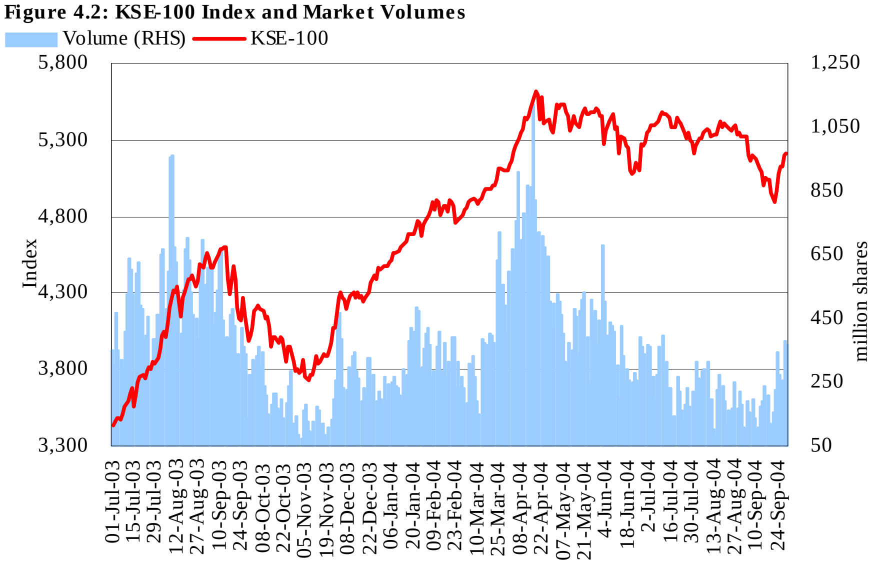
Source: World Bank

4.2 Market Develoments

The uptrend in KSE-100 Index that began in September 2001 continued to prevail in FY04 (see **Figure 4.2**). The rise in KSE-100 during early FY04 was initially led by the expectations of an expedited privatization of Pakistan State Oil (PSO) and exceptional results from Pakistan Oil Fields (POL). This, together with market interest in other energy stocks (such as Hubco) accelerated the market momentum.[66] As a result, the KSE-100 Index reached to 4604 points by September 12, 2003 (a 35 percent increase since June 2003).

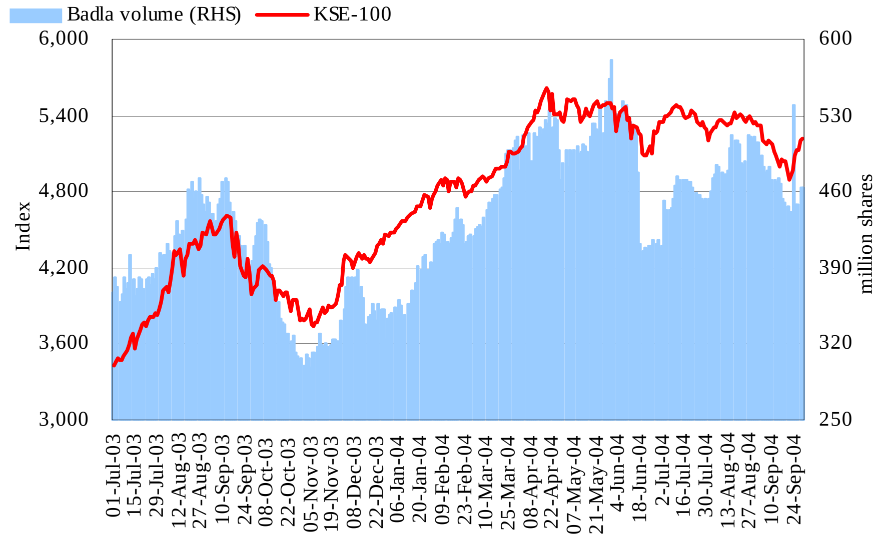
The KSE-100 however, could not maintain this uptrend mainly due to an increase in speculative investments. This was evident from a sharp increase in average badla volume that rose to 331.3 million shares in Q1-FY04 against 139.1 million shares in the same period last year (see **Figure 4.3**). Therefore, badla rates also went up to 14.6 percent (despite low interest rates in the inter-bank money market), in turn leading to a sell-off by weak holders.

Figure 4.2: KSE-100 Index and Market Volumes



[66] Since energy stocks had the highest share of 24 percent in total market capitalization at end-September 2003, movement in these scrips had a major impact on overall trends in the KSE-100 Index.

Figure 4.3: KSE-100 Index and Badla Volumes



In the meanwhile, the slow progress in privatization of PSO made market participants revise their bullish expectations. The resulting bearish correction was reinforced by other adverse developments such as an announcement of the abolition of badla market, PTCL's decision to cut line rent and installation charges, and new SBP regulation to limit banks' exposure in equity market. As a result, the index fell by 19 percent to 3732.3 points on 6th November 2003.

However, since the fundamentals remained favorable, once the badla overhang was reduced, the market was ready to resume its uptrend. The index reacted positively to favorable developments on the political front, such as improvement in relations with India and resolution of LFO issue.

The resulting bullish momentum of the KSE-100 Index prevailed into the early months of H2-FY04. This upbeat performance is mainly characterized by (1) increased investors' confidence which was reflected in heavy over-subscription of a number of new listings (see **Section 4.4**); (2) favorable corporate announcements (e.g., by PTCL, MCB, and NBP); and (3) expectations of strong cement sector results, amidst rising capacity utilization.[67] As a result, the KSE-100 Index

[67] The cement sector responded to the government's commitment of constructing at least one large dam in the country.

increased by 1888.1 points over its November 2003 trough to reach 5620.6 points on April 19, 2004 – a new all-time high for the KSE-100. This extraordinary performance was supported by increased market turnover that also crossed 1.1 billion shares on April 16, 2004 – another all-time high. However, this uptrend in KSE-100 Index was once again accompanied by rising badla volumes, indicating the renewed vulnerability of the Index to weak holdings. This vulnerability was yet again exposed in the final months of FY04 by a succession of negative developments which partially soured sentiments, and eventually led to a sharp correction in June 2004.

The market quickly recovered afterwards once badla volumes fell amidst renewed interest in blue chips such as PTCL, OGDC, MCB and NBP. However, the momentum of the rally was clearly hurt, and this was compounded by the taxes on capital market transactions announced in the FY05 Federal Budget speech (see **Table 4.3**). Until this budget, these transactions were not being taxed.[68]

Table 4.3: Taxes Imposed on the Equity Markets

Tax	Rate (percent)	Imposed on	Nature of Tax	Payer of Tax
Capital value tax	0.01	Value of share	Full and final	On purchaser of shares
Withholding tax	0.005	Value of share	Adjustable	On seller of shares
Withholding tax	0.005	Value of share	Full and final	Purchaser
Withholding tax	0.005	Value of share	Full and final	Seller
COT-WHT	10	Interest earned	Full and final	Badla (COT) financer

Not surprisingly, this led a market decline which saw the KSE-100 lose 279 points (5.2 percent) in the next 10 trading days amidst a big fall in trading volumes.[69] In fact, the loss would have been even greater if not for the 173 point jump stemming from the nomination of the highly regarded Finance Minister Shaukat Aziz for Permiership of the country, which allowed the market to close the year at 5279 points, up a net 54 percent for the year.

Thereafter, a combination of political shocks as well as uncertainity over the implementation of the new transaction taxes, kept the market volatile through July-August 2004. This phase continued into September 2004 when the market suffered another mini-collapse on the news that the carry over transaction (COT)

[68] In fact, given that the tax on commission income is now a full and final settlement of obligations, the effective tax rate on income of some brokers may actually decline, since incomes that would otherwise fall in higher tax brackets would now be taxed at the (low) fixed rate only.

[69] The average daily turnover declined from 390 million shares in the 30 days preceding the FY04 budget to 228 million shares in next 30 days.

financing would be replaced by the new margin financing rules. The added uncertainity caused the market to lose another 335 points in just 10 trading days to close at 4997.3 points on 15th September 2004, before the market finally broke out of its bearish mode on better than expected corporate results of large-cap stocks OGDC and PTCL. An added feature of this recovery was probably the market acceptance of the transaction taxes imposed in the budget. As a result, the KSE-100 index quickly recovered to close at 5217.6 points on September 30, 2004.

4.3 COT (Badla) Market

The COT market remained very buoyant throughout FY04, with investments averaging Rs 19.9 billion in FY04 against Rs 6.2 billion in FY03. The higher demand for badla investment increased the average badla rates to 11.4 percent in FY04 from 9.4 percent during the preceding year, even though interest rates remained low through most of FY04 (see **Figure 4.4**).

For the first quarter, while the index surpassed the 4500 psychological barrier, the badla rate also witnessed highs, ranging between 12.1 and 19.1 percent, with badla values averaging 18.8 billion Rupees. The higher badla rates were probably due to highly leveraged positions by the investors. This surge in speculative investments and the higher badla rates led to the significant market correction witnessed in Q2-FY04. As a result, the average badla rate in the quarter fell sharply to 10.7 percent as

Figure 4.4: Badla Volumes and Badla Rates

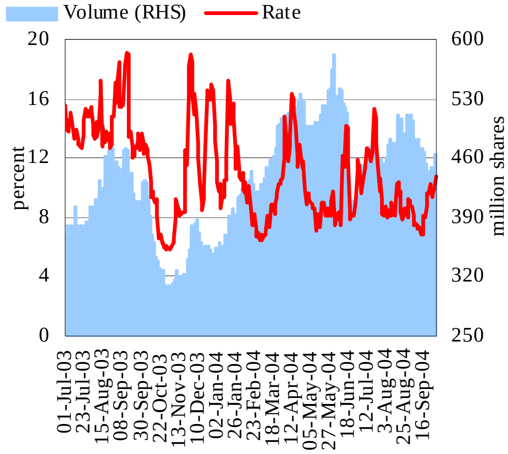
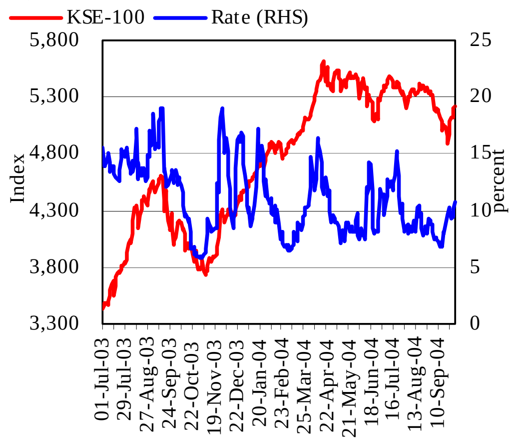


Figure 4.5: KSE-100 Index and Badla Rates



against 14.4 percent in the previous quarter.

The badla rates in Q3-FY04 also showed strong correlation with speculative behaviour of the market. The average badla rate in Q3-FY04 was 9.9 percent with badla investment averaging around Rs 19.8 billion. The market witnessed yet another wave of speculation during March-April 2004 while the index crossed 5600 barrier reaching at 5620.6 points on April 19, 2004. Accordingly, the badla rates again increased to the range of 14-16 percent. As **Figure 4.5** illustrates, the badla rate remained very volatile during FY04 despite fair amount of liquidity in the market.

4.4 Floatations in KSE

A total of 16 floatations took place in KSE in FY04 to raise Rs 55.6 billion, as against 6 flotatations in FY03 that rasied Rs 4.6 billion (see **Figure 4.6** and **4.7**).

The large contribution to this improvement was from public offerings of shares of state-owned enterprises. These comprised about a third of the offerings, and accounted for approximately 89 percent of the funds raised through the floatations in FY04. Moreover, given that the government offerings were at a discount, even the larger public offerings were heavily oversubscribed (see **Table 4.4**).

Figure 4.6: Size of New Listings

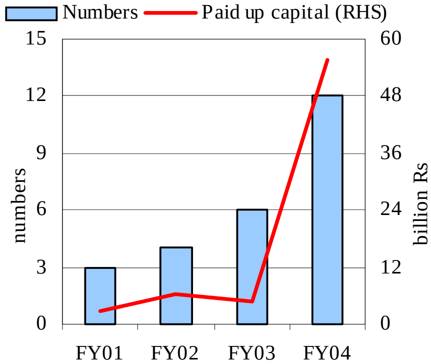
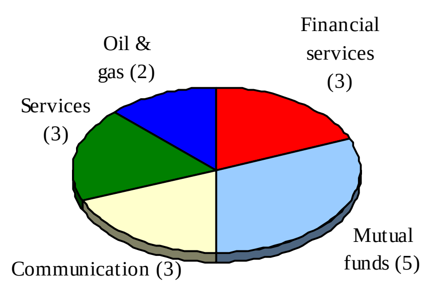


Figure 4.7: Floatations in KSE (FY04)



Note: Figures in parantheses represent number of floatations

4.5 Sector Wise Performance of Karachi Stock Exchange

The *Oil and Gas Exploration* companies witnessed the highest increase in market capitalization, which their share jumping to 21.7 percent by end-FY04 as compared to merely 2.8 percent by end-FY03 (see **Table 4.5**). The increase was mainly due to the listing of OGDC that alone has a weight of 21.7 percent in the

Table: 4.4: Floatations and Listings in KSE During FY04
Amount in billion Rupees

	Name of Company	Date of formal listing	Paid up capital	Offered amount	Amount subscribed	Times subscribed
1	Pakistan Container Terminal	23-Aug-03	638	160	1,341	8.4
2	National Bank of Pakistan		4103.422	604	1,222	2
3	First National Bank Modaraba		250	100	121	1.2
4	OGDCL	19-Jan-04	43,009	6,881	28,100	4.1
5	Worlcall Broadband Limited	23-Feb-04	1,500	300	1,976	6.6
6	Pakistan Capital Market Fund	8-Mar-04	1,500	375	2,031	5.4
7	SSGC			1747	13,000	7.4
8	MACPAC	2-Apr-04	389	150	474	3.2
9	ABAMCO Stock Market Fund	3-Apr-04	500			
10	ABAMCO Capital Fund	6-Apr-04	1,194			
11	Callmate Telips Telecom Limited	7-Jun-04	503	150	582	3.9
12	Southern Networks Limited	21-Jun-04	595	150	138	0.9
13	Bank Alfalah	5-Jul-04	2,000	1,200	11,801	9.8
14	PICIC Investment Fund	21-Jun-04				
15	ABAMCO Composite Fund	21-Jun-04	3,000	1,000	74	0.1
16	PIA		11,514	1,150	1,329	1.2

Table 4.5 Top Performing Sectors of KSE During FY04
billion Rupees

		Market capitalization		Traded value	
		Total (million Rupees)	Share (%)	Total (million Rupees)	Share (%)
1	Oil & Gas Exploration Companies	307,858	21.7	473	19.9
2	Cement	68,824	4.8	431	18.1
3	Oil & Gas Marketing Companies	111,767	7.9	314	13.2
4	Transport	28,413	2.0	227	9.5
5	Commercial Banks	116,440	8.2	219	9.2
6	Technology & Communication	168,558	11.9	160	6.7
7	Investment Banks/Cos./Securities	34,133	2.4	111	4.7
8	Fertilizer	75,614	5.3	109	4.6
9	Power Generation & Distributions	64,244	4.5	74	3.1
10	Textile Composite	34,082	2.4	68	2.9
11	Insurance	29,571	2.1	47	2.0
12	Synthetic & Rayon	33,266	2.3	43	1.8
13	Close-End-Mutual Funds	18,844	1.3	38	1.6
14	Chemicals	52,423	3.7	25	1.1
15	Automobile Assembler	33,751	2.4	14	0.6

KSE-100 Index. In contrast, the market capitalization of Oil Marketing companies decreased substantially from 11.4 percent in FY03 to 7.9 percent in FY04 on account of underperformance and much less than expected corporate results. Within the sector, PSO accounted for almost two-third of the turnover of shares traded.

The effect of the increase in demand for cement contributed significantly towards increasing the market capitalization of this sector. Moreover, heavy trading was also observed in the cement sector. Shares of companies like DG Khan cement, Lucky cement and Maple Leaf cement continued to trade heavily in the latter half of FY04.

Furthermore, blue chip companies such as Hubco and PTCL continued to dominate in the market on account of expectations of greater profitability. Newly listed OGDC also witnessed exceptional trading volumes during FY04. This was proably due to the inclusion of this scrip in the KSE-100 following its recompostion.

In the latter half of FY04, the market also witnessed increased trading in shares of banks amidst expectations of good profit growth in the industry. The shares of Bank of Punjab, MCB and Askari Commercial Bank in particular, were heavily traded in the market

4.6 Corporate Earnings

As mentioned earlier, one of the reasons of the remarkable growth of KSE-100 in FY04 was the expectation of the increased profitability of listed companies. The overall corporate sector showed noteworthy performance in FY04 as compared to the preceding year. The **Table 4.6** highlights the sector-wise profits after tax (PAT) of 265 companies listed on the KSE.

Cement sector's earnings grew very robustly in FY04; not only did the sector benefit from rising domestic demand and exports, it also benefited from the re-structuring of its debt as well as lower fuel costs due to the shift from furnace oil to cheaper fuels (gas and coal). The exceptional increase in demand for cement, such as the emphasis of government on boosting the construction sector (including expectations that the government would initiate a new dam), construction of Gwadar port and contribution in rebuilding of Afghanistan, led to increase in capacity utilization by most of the cement manufacturing companies.

Similarly, the transport sector also witnessed tremendous growth of 241.5 percent in FY04 amid the increase in revenue of both PIA and PNSC (as well as a low-

Table 4.6: Corporate Earnings

PAT in Million Rupees	PAT 2003	PAT 2004	Growth	Cash Dividend (%) 2003	Cash Dividend (%) 2004	Bonus (%) 2003	Bonus (%) 2004
Cement	93.96	4600.72	*4796.42*	4.01	7.2	0.61	4.15
Transport	485.83	1659.12	*241.5*	4.81	6.42		3.06
Cable & electric goods	139.91	331.64	*137.03*	4.21	8.3	10.6	13
Inv Banks / Inv. Cos	2424.97	5127	*111.43*	13.81	21.31	9.18	12.26
Auto parts & accessories	331.01	604.5	*82.62*	16.73	8.63	0.51	1.11
Synthetic & rayon	577.77	1051.59	*82.01*	6.31	6.97	0.49	4.31
Pharmaceutical	136.82	246.99	*80.59*	20.1	16.92	3.18	7.16
Miscellaneous	203.93	362.56	*77.79*	2.66	9.3		2.56
Tobacco	731.3	1279.4	*74.95*	85.29	121.68	16.22	
Textile weaving	5.81	8.21	*41.37*				
Leasing	707.62	991.46	*40.11*	9.25	10.47	2.31	4.09
Engineering	630.87	820.04	*29.99*	28.22	34.89	4.59	5.85
Tech & comm.	23441	29457.72	*25.67*	30.29	43.28	0.54	
Glass and ceramics	323.98	401.8	*24.02*	7.64	6.22	6.14	5.5
Refinery	2455.91	2974.99	*21.14*	78.74	93.12		
Auto assembling	2770.74	3336.28	*20.41*	41.82	48.84		4.12
Modaraba	997.12	806.1	*19.16*	7.91	7.76		
Close end mutual funds	4525.83	5265.79	*16.35*	6.19	11.39	2.55	5.92
Oil and gas exploration	28121.78	32095.53	*14.13*	6.99	42.76	0.96	
Oil and gas marketing	6777.04	6784.92	*0.12*	59.06	59.7		
Power generation	6617.39	6338.94	*-4.21*	44.65	27.34		
Paper and board	869.92	799.07	*-8.14*	46.58	42.26		0.84
Food & personal care products	611.08	534.76	*-12.49*	27.1	28.55	4.26	2.14
Textile composite	158.05	133.15	*-15.76*	9.18	9.18		
Woolen	7.41	3.78	*-48.96*	4.11			
Sugar and allied	34.52	15.04	*-56.42*	10			
Jute	-17.78	-21.16					
Chemical	-12.63	390.34		8.31	9.39		0.32
Vanaspati and allied	-70.83	-29.23			1.38		
Leather and tanneries	-31.95	-11.73		3.95	4.87		
Total PAT	84048.38	106359.32	*26.5*				

base effect). The shipping business of PNSC experienced 14 percent growth that also contributed in increasing its PAT by almost 250 percent in FY04. The performance of *investment banks and investment companies* was quite exceptional in FY04 as reflected by the growth of 111.4 percent in the aggregate profits of companies in this group. Investment companies, reflecting the continued strength of the domestic stock market rally, accounted for most of this increase.

The Synthetic and Rayon sector posted 82 percent higher profits in FY04 as compared to FY03 on account of the tremendous growth in the profitability of

Dewan Salman Fibre.[70] Meanwhile, the growth in the *Auto parts and Accessories* sector that was primarily due to an increase in sales of cars by 32 percent in FY04 boosted its profits by 82.6 percent.[71]

The technology and communication sector witnessed 25.6 percent growth in FY04. In particular, PTCL showed an impressive growth of 26.3 percent as its PAT increased to Rs 29.16 billion, reflecting an aggressive growth strategy.[72] The Oil and Gas sector listed on KSE also witnessed tremendous increase in its PAT with the inclusion of OGDC that alone posted a profit after tax of Rs 32.1 billion as compared to Rs 28.1 billion in the preceding year. This is primarily due to an increase in gas production from new oil fields and expansion in existing installations.

In the power sector, Hubco and other IPPs posted negative results mainly due to following reasons: (1) appreciation of Pak Rupee has led to a decline in their Rupee revenue as the tariffs received by the IPPs are denominated in US Dollar terms (but payable in Rupees); (2) increase in the share of hydel power in total electricity generation due to better availability of water in FY04. However, going forward, shortage of water in FY05 offers better prospects through higher demand for this sector.

4.7 Corporate Debt Market

The declining issuer interest in the listed corporate debt market that was evident in H2-FY03 became even more pronounced in FY04; there was only 6 issues during the year (raising only Rs 3.3 billion), compared to 22 in FY03 (for Rs 11.1 billion) and 17 in FY02 (for Rs 10.1 billion).

This probably reflects the competitive credit market, and the aggressive marketing of loans by banks. It should be noted that the prime issuers in the debt market had traditionally been the better-rated domestic corporates, which are typically offered extremely competitive rates by banks. Another possible reason for the low issuer interest could simply be the increased use of retained earnings amidst a rise in corporate profitability.

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[70] The PAT of Dewan Salman Fibre grew by 1054.6 percent in FY04 and accounted for 31.1 percent of Synthetic and Rayon Sector.

[71] It may also be noted that the sales of cars also recorded a phenomenal increase of 46.2 percent in FY04 over the preceding year.

[72] While expanding its installed capacity, the PTCL has reduced its call charges and line rent. In addition, it has also increased its aggregate fixed-line customer base to over 4.4 million.

Table 4.7: New Floatation in FY04
Amount in million Rupees

	Issue Date	Maturity Date	Amount	Rate of Return
Pacific Leasing	7 Jul-03	Jul-07	320	DR + 2%; floor 10.5%, cap 13.5%
First Oil & Gas (OPI)	4 Sep-03	4-Nov-06	1,000	SBP discount rate + 2.5% Floor 10.50%, Cap 14.50%
Pharmagen Limited	16-17 Oct-03	17-Oct-08	300	W.A. Yield of 5 yrs PIB + 2.50% Floor 8.50%, Cap 11.50%
Pakistan Services Ltd.	19-12 Nov-03	12-Nov-08	700	SBP discount rate + 2.5% Floor 9.75%, Cap 13.75%
Al-Zamin Leasing Modaraba	23-24 Dec-03	23-Dec-08	250	Expected minimum 8% on Profit & Loss basis
Union Bank Limited II	19-20 Jan-04	30-Dec-10	750	Cut-off yield 5-year PIB + 0.75 (floor 5%, Cap 10.75%)

The structure of the few TFC issues that were undertaken also reveals interesting insights on the debt market. As shown in **Table 4.7**, all were floating rate issues, and most had a floor *and* a cap (minimum floor rate offered was 8.0 percent and maximum yield was11.50 percent), as both issuers and potential investors sought protection against adverse interest rate movements (see **Table 4.8**).

Table 4.8: Overall Composition of Listed TFCs

	FY01	FY02	FY03	FY04
Total issued	**11**	**17**	**21**	**6**
Fixed	7	4	0	0
Floating	4	13	21	6
Anchored to Discount rate	3	8	13	3
Anchored to PIBs	1	5	8	2
Anchored to Profits	0	0	0	1

Among the listing of new debt instruments in FY04, half of the instruments were linked with the SBP discount rate (that remained stable at 7.5 percent throughout FY04). No TFC was issued with a fixed rate of return.

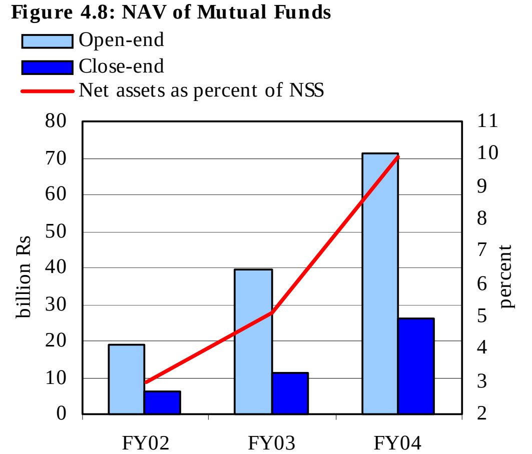
4.8 Mutual Funds

The mutual fund industry has also seen significant growth in FY04 amidst increasing investor interest from both individuals and institutions. As a result not only has the number of funds increased substantially during the year (see **Table 4.9**), but the Net Asset Value (NAV) of the mutual fund industry at end-FY04 nearly doubled relative to that at end-FY03 (see **Figure 4.8**). To put this growth in better perspective, it is instructive to note the rise in the NAV of the mutual funds industry relative to the outstanding stock of NSS instruments, which have traditionally been a favored haven for savings (see **Figure 4.9**). Also, the ratio of

Mutual Funds NAV to banks deposits has risen from 1.8 percent in FY02 to 4.9 percent in FY04.

However, despite this robust growth, Pakistan's mutual fund industry is clearly still underdeveloped, with only a total of 31 funds and total net assets of Rs 97.3 billion (US$ 1.66 billion) which is 1.7 percent of GDP. In contrast, the mutual fund industry in India comprises of 33 Mutual Funds offering more than 400 schemes, and with the net assets of around US$ 33 billion (5.9 percent of GDP).

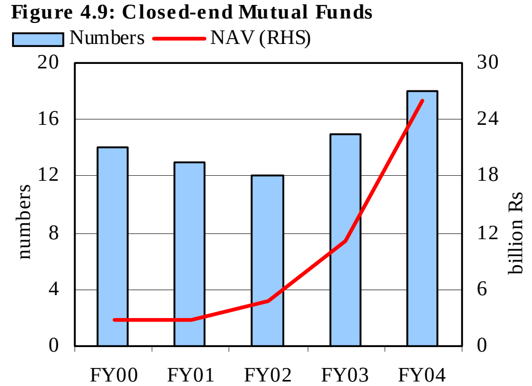
Figure 4.8: NAV of Mutual Funds



Closed-End Mutual Funds

The number of closed end Mutual Funds has increased from 15 in FY03 to 18 in FY04 with asset under management rising 135.1 percent YoY to Rs 26.1 billion. Thus, in aggregate, the growth in the industry NAV is higher than the 58.2 percent YoY rise in the KSE-100.

Figure 4.9: Closed-end Mutual Funds



While the cash payouts by closed-end funds have decreased from 16.1 percent in FY03 to 14.6 percent in FY04, the bonus and right share issues have increased substantially in FY04. The bonus payouts increased by 46.6 percent whereas the percentage of right shares in

Table 4.9: Closed End Mutual Funds

	Number of Funds	Paid-up capital (billion Rs)	Percent share of KSE-100
FY99	14	3.63	1.27
FY00	14	3.63	1.31
FY01	13	3.63	1.54
FY02	12	3.53	1.21
FY03	15	3.65	1.17
FY04	18	4.09	1.09

Source: Mutual Funds Association of Pakistan total payouts has increased from 78.1 percent in FY03 to 89.1 percent in FY04. This contributed to the decline in the *NAV per share* of closed-end mutual funds, even as aggregate Net Assets under management increased

Open-end Mutual Funds

Net Asset Value (NAV) of open-ended mutual Funds saw a substantial increase in FY04 as the growth in these was not limited by a fixed capital base. The aggregate net assets under management of mutual funds thus increased by a very substantial 81.2 percent, much faster than growth of the KSE. This reflects the capital additions through sales of units as well as the appreciation in the value of investments.

Table 4.10: Prices and NAV of Close-End Mutual Funds as on 30 June FY04

Prices in Rupees

	Price 2003	NAV 2003	Price 2004	NAV 2004	Payout 2003	Payout 2004
Al-Mezan Mutual Fund	19.55	18.63	15.8	14.55	20%10%B200%R	10%15%B
Asian Stock Fund	3.5	5.91	9.7	6.51		800%R
BSJS Balanced Fund	21.7	19.46	12.95	15.44	15%10%B200%R	12.5%B
Dominion Stock Fund	7.5	3.74	3.35		2%	
First Capital Mutual Fund	5.55	8.85	6.85	7.9	25%	
Golden Arrow	6.95	7.39	18.6	9.46	22%24%B	17.5%20%B300%R
Investec Mutual Fund	7.8	2.87	2.8		2%	
4th ICP Mutual Fund	40.9		35.5	46.36	42%10%B135%R	25%B100%R
ICP SEMF	48.25		47.05			
PICIC Investment Fund			18.15	19.96		25%
Pakistan Capital Market Fund			10.15	9.97		8.25%
Pak. Premier Fund	14.4		19.2	18.01	12.5%B50%R	12.5%25%B50%R
Prudential Stock Fund	3	4.26	7.05			
Safe Way Mutual Fund			16		10%B	150%R
Tri Star Mutual Funds	1.7		3		1%	

Source: Karachi Stock Exchange

R=Right shares; B=Bonus shares

4.9 Margin Financing

The carry-over transaction (COT or *badla*) financing is widely used in Pakistan's equity markets as a means to defer settlement of trades[73] (thereby enabling leveraged investment positions). The financing cost, which is determined daily by the market, is a function of the particular stock for which *badla* is being sought; the costs varies from stock to stock and can vary abruptly from day to day, in response to supply and demand in the scrip. Therefore, it is not unusual to the see the *badla* rate moving in opposing direction for different stocks in the same trading day. There is only a loose relationship between market interest rates and the prevailing badla rate.

The badla market associated with the KSE deals in financing scrips of only 29 companies, the aggregate trading volume for which typically accounts for almost 90 percent of the total market volume. It is important to note that while the *badla* transactions are documented, the sources of the *badla* financing is opaque, and fluctuations in *badla* costs have been alleged to be the cause of market instability.[74] Moreover, *badla* is also a source of systemic risk. On the other hand, the availability of the badla has certainly contributed significantly towards improving the market liquidity.

Thus, in order to improve systemic risk and transparency but protect market liquidity, the SECP has begun a gradual phase-out of *badla*, replacing it with a margin financing mechanism that allows leveraged transactions but significantly reduces systemic risk and strengthens market integrity.

The salient features of margin financing are:

- Unlike *badla* financing, which is obtainable after shares have been purchased and requires no collateral other than the shares purchased, margin financing requires the availability of the margin (collateral) *before* a purchase can be transacted. The shift to margin financing, therefore could in theory, reduce the transacted volumes in the market. This was indeed witnessed in India when the market similarly shifted from badla to margin financing.

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[73] Trades are carried to the next trading day through a repurchase agreement. The price differential (other than the broker's commission on the trades) comprises the cost of the *badla* financing for the investor.

[74] In fact, in order to curtail the risk of an induced fall in the market, the KSE introduced regulations in 2002 restricting the abrupt withdrawal of COT funding from the market.

- Only institutions and brokers registered with the SECP and maintaining the required minimum paid-up capital are allowed to extend margin financing to customers.

- Moreover, banks / DFIs will extend financing only to those brokers that are constituted as limited companies and are registered with a credit rating agency. Moreover, the brokers will have to meet capital adequacy requirements.

- However, banks/DFIs will have to follow Prudential Regulations of the SBP under which the aggregate credit extended cannot exceed 10 times the paid-up capital and reserves of the broker. Furthermore, the banks / DFIs will also maintain minimum margin on advance to brokers. This minimum limit is to be determined by each bank in accordance with its own credit policies and the SBP regulations, but must be communicated to the SBP.

- The brokers and the investors will have to maintain separate accounts with the Central Depository and the broker will be required to enter into a margin agreement with its clients that include conditions regarding pledge of securities bought on behalf of investor and the minimum margin to be maintained.

- The banks/ DFIs may or may not extend credit on the purchase of scrips of different companies at their sole discretion. However, it is envisaged that the number of scrips eligible for margin finance will increase substantially, potentially helping increase liquidity and depth in the equity market.

In the short run, with investors uncertain of the impact of the shift from badla to margin financing, it is possible that brokers would prefer to slow down the phased transition. However, it is expected that the elimination of badla will help bring greater stability to the domestic equity market, and the reduced systemic risk would consequently help increase the investor base. Moreover, the equity market would become increasingly integrated with the other financial markets in Pakistan.