PAKISTAN

- **1947–1949** The Karachi Stock Exchange (KSE) is established in September 1947 and formally incorporated in March 1949
- **1970** The Lahore Stock Exchange (LSE) is established in October
- **1989** The Islamabad Stock Exchange (ISE) is established in October
- **1991** The KSE-100 Index is introduced in November with a base value of 1,000 points
- **1995** Private sector allowed to launch open-end funds
- **1999** The Securities and Exchange Commission of Pakistan (SECP) is established and replaces the Corporate Law Authority as the apex regulator
- **2002** The Karachi Automated Trading System is launched
- **2007** The Pakistan Mercantile Exchange commences operations
- **2012** The stock exchanges are demutualized
- **2014** Trading of government securities allowed on the Bond Automated Trading System (BATS)
- **2016** KSE, LSE, and ISE merge to form the Pakistan Stock Exchange (PSX) in January
- **2017** A consortium led by Chinese exchanges acquires a 40% stake and control in PSX; Pakistan upgraded to MSCI Emerging Markets status
- **2020** First exchange-traded funds (ETFs) launched in March

PAKISTAN

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Equity Market Capitalization (USD)	**47.49** Bn
Equity Market Cap/GDP	18%
Equity Market Share Volume Traded	**302** Mn
Number of Listed Companies	530

113.7 Bn	Debt Market Capitalization (USD)
45%	Domestic Debt Market Cap/GDP
940 Mn	Debt Market Instrument Volume Traded (USD)
106*	Number of Issuers (Bonds)

Note: Data as of September 2020
* Excludes government bonds

Formal capital market activity in Pakistan began with the establishment of the Karachi Stock Exchange (KSE) in 1947. Initially, just five companies were listed (several of which are still listed today); this number grew to 81 by 1960 and then to 219 by 1970. The rapid progress in the 1960s coincided with an industrialization drive and high average GDP growth (6.8% per annum). Momentum was lost in the 1970s with the separation of East Pakistan (now Bangladesh) and the introduction of nationalization policies, before the 1980s saw the renewed encouragement of private enterprise. The formation of the Lahore Stock Exchange (LSE) in 1970 and the Islamabad Stock Exchange (ISE) in 1989 neatly frames this period. A turning point occurred in the 1990s with a combination of privatization and other measures to liberalize the economy, with the encouragement of the International Finance Corporation. Steps included the opening of the market to international investors and removing constraints to the repatriation of investment proceeds. This period also coincided with the introduction of a central depository for securities and the establishment of the Securities and Exchange Commission of Pakistan (SECP). The Central Depository Company of Pakistan (CDC) helped facilitate a shorter settlement cycle, catalyzed higher trading activity, and paved the way for the introduction of electronic trading. Despite intermittent periods of political volatility and poor security conditions, the subsequent market growth and development has been relatively rapid. From its launch in 1991, the benchmark KSE-100 Index has posted an annualized return of almost 15% (approximately 8% per annum in US dollars), and more than 500 stocks are now listed, with a combined market capitalization of more than USD50 billion.

Today, the Pakistan Stock Exchange (PSX) is the sole stock exchange in the country, formed after the merger of KSE, LSE, and ISE in 2016. A year later, in 2017, it was majority acquired by a consortium led by the China Financial Futures Exchange, the Shanghai Stock Exchange, and the Shenzhen Stock Exchange. These developments followed the demutualization that took place in 2012, as the exchange evolved from the broker-owned model. The operational architecture at PSX allows for electronic trading, clearing, and settlement, supported by CDC and the National Clearing Company of Pakistan Limited. This includes the trading of fixed-income securities as well, issued by both the government and the private sector. The regulatory environment for capital market activity in Pakistan is comparable to that of several regional peers. This was acknowledged by MSCI's decision to once again upgrade Pakistan to Emerging Markets status in 2016–2017, marking a return to when Pakistan was formally recognized as an Emerging Market in 1994.

EQUITIES

Buoyed by the economic liberalization of the 1990s, the market capitalization to GDP for Pakistan's equity market quickly moved from the single digits in the early part of the decade to the mid-teens by 1998. However, Pakistan's nuclear tests in 1998 sparked a chain of events that culminated in a military takeover. Market capitalization plummeted back to the single digits and recovered only in the mid-2000s. As Pakistan once again became an attractive investment destination, given its quickly growing economy, equities widely outperformed other asset classes during 2003–2007, with market capitalization to GDP expanding to a peak of approximately 45%. Equities suffered again during the global financial crisis, but the market capitalization to GDP in Pakistan has not fallen back into the single digits since, not even during the height of the COVID-19 pandemic. In P/E terms, Pakistan's valuations have typically fluctuated between 6× and 12×, with a long-term mean of approximately 9×.

The next phase of stock market development might see the fruits of the structural reforms undertaken in the past decade. Pakistan has been under democratic rule since 2008, the erstwhile energy deficiency has been greatly addressed, security conditions are the best in many years, and the government is making concerted efforts to deliver more sustainable and inclusive economic growth. This growth can provide a conducive environment for new listings, product innovation, and greater participation from the domestic retail investor base. In 2020, despite the challenges posed by the coronavirus pandemic, IPOs were oversubscribed, exchange-traded funds (ETFs) were launched for the first time, and the trading regime saw the introduction of index halts and wider circuit breakers (±7.5% for individual stocks, compared with ±5% earlier).

Major Equity Indices

Pakistan's benchmark stock index is the KSE-100, which replaced the KSE-50 in 1991. Several other indexes are available on PSX, including the KSE-30, the KSE All Share, the KMI-30, and the KMI All Share. The latter two indexes represent Shariah-compliant stocks, a popular category given that more than 95% of Pakistan's population is Muslim (the country's largest private sector asset management company is Islamic). The benchmark index, however, remains the KSE-100, which captures approximately 80% of the market capitalization of the KSE All Share Index. **Figure 1** shows the level of the KSE-100 since 2000.

Because the component weights of index companies are based on their free float market cap, several large listed multinational companies, such as Nestle, Colgate-Palmolive, and Philip Morris, have a relatively small bearing on the KSE-100 index. This became more the case after the early 2000s, when several large local banks and oil and gas exploration companies were listed. As can be seen in **Figure 2**, these two sectors today have a combined weight (free-float based) of approximately 40% in the KSE-100. The distribution of sector weights is more balanced on the KSE All Share Index, which incorporates the full market capitalization methodology, but some prominent absentees still exist. Like other emerging and frontier markets, sectors such as technology, real estate, and retail trade are not well represented at PSX. As companies in these sectors take on a more formal structure and become larger, they might well choose to list going forward. This scenario is what appears to have happened in the steel sector, with several steel manufacturers listing in the previous five years.

Of the more than 500 stocks listed on PSX, 9 have a market capitalization of more than USD1 billion, 12 have a market capitalization between USD500 million and USD1 billion, and nearly 70 have a market capitalization ranging from USD100 million to USD500 million. The number of stocks that traded more than USD0.5 million per day in 2020 stands at more than 40. As interest rates have declined sharply, local liquidity has significantly improved, and fiscal year 2021 commenced with an average daily turnover in excess of USD110 million, up from USD66 million over the previous fiscal year. This improvement has come about in the absence of large leverage in the system. Direct in-house financing by brokers was a key reason for the higher trading activity in the past but has not been allowed in recent years. Eligible financing products such as the Margin Finance System and the Margin Trading System are available, but their depth is minimal for now. Going forward, with the SECP consistently pushing better risk management and compliance, market leverage and liquidity could improve. A natural

FIGURE 1. KSE-100 INDEX (COMPOUND ANNUAL GROWTH RATE = 18%)

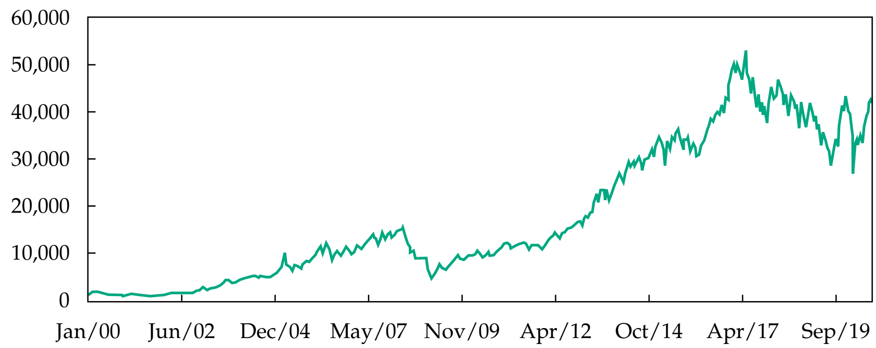
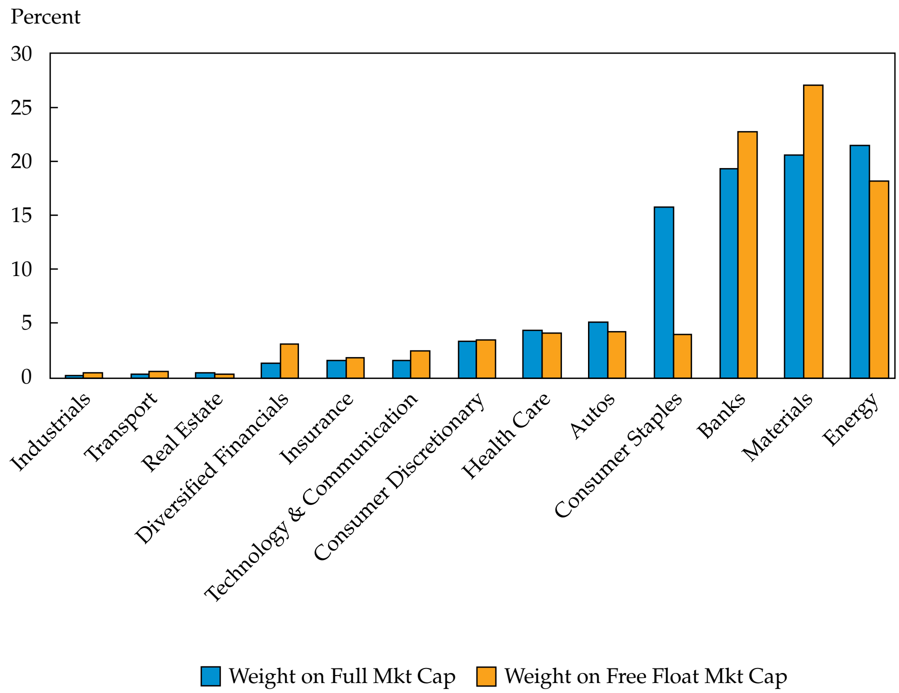


FIGURE 2. KSE-100 INDEX: SECTOR WEIGHT DISTRIBUTION



increase in trading activity should also occur as the number of retail investors increases and as institutional assets under management (AUM) grow, particularly for local mutual funds and insurance companies.

Historical Turnover

At present, Pakistan has fewer than 275,000 central depository account holders (0.13% of the population), compared with more than 2 million in Bangladesh (1.3% of the population) and 25 million in India (2% of the population). Despite what is clearly a low level of retail investor penetration, individuals contribute approximately two-thirds of the local gross trading activity in Pakistan. This is possibly due to the outsized influence of high-net-worth individuals and a retail base that perhaps makes up for its small numbers with a high activity level. The next most active category is broker proprietary trading, followed by local mutual funds and foreign investors. The size of the local mutual fund AUM was last recorded at USD5.1 billion, of which USD1.5 billion is dedicated to equities (conventional and Islamic). If interest rates remain low and the equity market continues to perform well, mutual funds might be able to attract additional flows.

Foreign Investors in Pakistan—Key Highlights

Foreign institutional investors have been active in Pakistan since the 1990s and own an estimated USD3 billion of Pakistani equities (approximately 25% of the free float). No foreign ownership limits are in place, except for a few companies (e.g., PSX itself). Both foreign and local investors have to notify ownership levels of 10% and higher to the stock exchange, while special permission from the central bank is needed to build a 5% or higher stake in a commercial bank.

Foreign investors are treated similarly to local investors on taxation. Repatriation of investment proceeds takes place through Special Convertible Rupee Accounts.

Pakistan is part of the MSCI Emerging Markets (EM) Index, albeit with a very small weight of 2 bps. Currently, three stocks are part of the standard MSCI EM Index—namely, Oil and Gas Development Company, MCB Bank, and Habib Bank Limited. More than 20 stocks are part of the MSCI EM Small Cap Index. Before upgrading in 2017, Pakistan had an 8% weight in the MSCI Frontier Markets Index.

A few Pakistani stocks are listed abroad through global depositary receipt issuances. Global ETFs tracking Pakistan are also available.

BONDS

The banking sector reforms of the 1990s saw the development of the bond market, with the auctioning of short- and long-term government securities, which replaced the tap sale of government paper. March 1991 saw the first auction of the six-month Treasury bill (T-bill) as well as the Federal Investment Bond (FIB), with maturities of 3, 5, and 10 years. The FIB was replaced by Pakistan Investment Bonds (PIBs) in 2000, and a yield curve started to develop with participation through competitive bids. As the banking sector grew, an interbank money market began to develop, which subsequently transitioned into a secondary market.

Today, Pakistan's fixed-income market is dominated by government securities, with approximately 80% of domestic public debt (USD108 billion) in the form of tradable T-bills and PIBs. These securities are primarily held by the central bank and financial institutions. OTC trading in these instruments is active. The average daily trading volume in government instruments (conventional and Shariah compliant) was close to USD1 billion in fiscal year 2020.

PSX provides a full suite of trading services through its Bond Automated Trading System (BATS) for corporate debt instruments (term finance certificates, or TFCs) and government debt securities. The latter have been available for trading on BATS since 2014, offering the retail segment a liquid and direct platform for trading in government securities. **Table 1** shows the secondary market trading activity in government securities.

CDC has earmarked special participant status in the Pakistan Real-time Interbank Settlement Mechanism and Real-Time Gross Settlement system to ensure transparency and smooth execution of system-based transactions. Investors can also use Investor Portfolio Services (IPS) with CDC to open IPS accounts for investment in government securities.

Similar to its equity market, Pakistan's domestic fixed-income market is open to foreign investors via Special Convertible Rupee Accounts. Via this special window, foreign investors can invest in local-currency government debt securities and also make use of tax concessions (10% compared with 30% for resident investment). Total foreign inflows in Pakistan government securities during fiscal year 2019–2020 rose to approximately USD3.5 billion (primarily in T-bills).

Pakistan's corporate debt market is relatively smaller, with total outstanding issues of approximately USD4 billion (approximately 1.5% of GDP) by more than 100 issuers. After the

TABLE 1. GOVERNMENT SECURITIES: SECONDARY MARKET TRADING VOLUME (PKR BN)

	FY18	FY19	9M FY20
T-Bills			
3 months	20,118	23,330	12,452
6 months	3,147	41	2,314
12 months	258	33	4,741
	23,523	**23,404**	**19,507**
PIBs			
3 years	1,062	1,596	2,713
5 years	1,031	889	973
10 years	928	1,017	1,266
15 years	10	1	-
20 years	11	1	9
	3,042	**3,503**	**4,961**
Government Ijara Sukuk	992	2,202	3,635
Grand total	27,557	29,109	28,103
Daily average volume	112	118	156

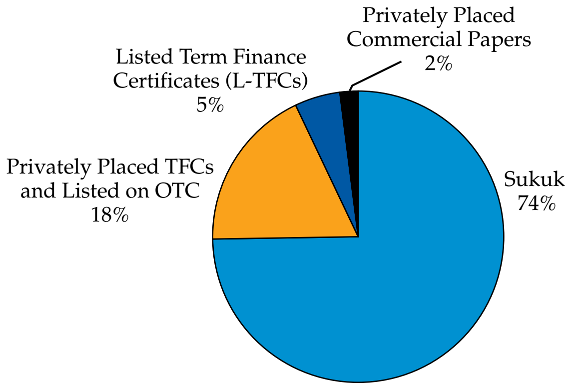
Source: State Bank of Pakistan.

nationalization policies of the 1970s, the first corporate bond was issued in 1988 by WAPDA, the national power utility at that time, and not until 1995 were private companies again allowed to issue corporate bonds. This delayed start, among other factors, has meant that Pakistani corporates still rely mainly on bank financing for their needs.

The investor base in the corporate debt market is primarily institutional, with low participation from the retail sector. Some of the factors behind the small size of the corporate debt market and limited retail participation include the following: (i) a low savings-to-GDP ratio (less than 20%), (ii) crowding out due to competition from the government's National Savings Scheme (NSS), and (iii) issues such as low liquidity, lack of benchmark rates, and high costs of issuance. Some of these issues are structural, whereas some could improve with time. To promote the listing of debt securities, regulatory requirements for operational history, credit rating, and audited accounts (reduced from five years to two years) have been relaxed.

Furthermore, since 1 July 2020, institutions have again been disallowed from investing in NSS products, which could divert funds toward the corporate bond market. Also, almost 75% of the corporate debt issuances by value are through sukuk (see **Figure 3**), in sharp contrast to the sovereign debt market, which continues to be dominated by conventional instruments. The success of sukuk might show the corporate

FIGURE 3. DOMESTIC CORPORATE DEBT MARKET



bond market a way to attract more institutional interest (Islamic banks cannot invest in T-bills or PIBs) and retail participation, as has been ably demonstrated by recent successful sukuk issuances by K-Electric, Pakistan's largest private sector utility company.

Over the years, the government has attempted to reduce volatility in the fixed-income market with a structured approach to fixed-income auctions. The acceptance ratio has been in the 28%–56% range, with gradual issuance of bonds in the secondary market, and this has helped the government in reducing its fiscal costs. The government's recent emphasis has been on diversifying the available fixed-income products and elongating the maturity profile of its domestic debt. In this regard, the government has introduced new products, such as floating-rate bonds with 3-year, 5-year, and 10-year maturities. The government has also started reissuing 15-year fixed-rate PIBs.

On the Islamic front, the government has introduced five-year floating-rate sukuk, issued in the primary market along with conventional instruments. Moreover, the government issued Pakistan Energy Sukuk in March 2019 and March 2020 (two separate issues) via the "reverse Dutch auction" to tap the Shariah-compliant debt market, with the proceeds to be used to improve liquidity in the energy chain. In July 2020, the privately placed Pakistan Energy Sukuk-II of approximately PKR200 billion was listed on PSX, which marked an important milestone because it was the first debt issuance through book building in Pakistan. Equity IPOs already take place through book building and the "Dutch auction" method.

CHALLENGES, OPPORTUNITIES, AND THE WAY FORWARD

Unlike many others, Pakistan is a market where a negative perception continues to permeate deeply. A recent quote from Mattias Martinsson, chief investment officer and founding partner at Tundra Fonder AB, one of the active foreign institutional investors in Pakistan, aptly summarizes this situation and highlights why opportunities are sometimes missed in this market by international US-dollar-based investors:[1]

> One of the most common questions we get is: How come you are so positive towards Pakistan?
>
> There are two reasons why we believe this market long-term provides a unique opportunity within the low-income and lower-middle-income countries:
>
> (1) Its financial infrastructure for investors in listed equity is among the best in our universe. You can choose a sector and favorite company within that sector, as opposed to investing in whatever is available in similar markets.

[1]Interview: Mattias Martinsson, "DeepDive: Investing in Pakistani Equities," 7 July 2020.

> (2) The Perception Arbitrage—As a local entrepreneur put it: "95% of what is written about Pakistan is about the 5% negative." I should not have to explain that when most investors are negative without even looking, it leaves a lot of potential on the table for those that take a neutral stance.

The catalyst for immediate change can come from the Chinese ownership at PSX and the appointment of new senior leadership. Early in 2020, the first two ETFs at PSX were launched. As new products come through, this could significantly increase market trading volumes and investor participation in the stock market. On the fixed-income side, the first ever government bond (a 10-year sukuk) was listed in July 2020, and the potential for the government to raise money for infrastructure projects from retail investors in the future is immense. Going forward, local product development can dovetail with possible cross-border listings and investments from China.

A long-standing challenge in the local capital markets is the participation of only a small retail investor base. The total number of investors is less than 300,000, investing either directly or through mutual funds (excluding those investing through retirement funds). Given the size of Pakistan's population and its tilt toward the young and middle-income segments—an estimated 40% of the population belongs to the middle class (80 million people), and approximately 50% of the population is younger than 24 years old (another 40% is between 25 and 54 years)—this is a market ripe for disruption. Technology is a key factor that could help bring about quick change, with approximately one-half of the country's 167 million cellular phone subscribers now on 3G/4G, alongside a similar number of broadband subscribers. With brokerage business models more feasible after the 15 bp commission rate floor in 2019, local brokerage firms may now look to increase their marketing efforts as well. Such efforts should find fertile ground in the recently launched Roshan Digital Accounts, via which the government allows overseas Pakistanis to digitally open bank deposit accounts in Pakistan and use those funds to invest in the capital market. Given that the Pakistani diaspora is large, this development could result in a notable flow of funds. More vibrant capital markets might also attract many of Pakistan's high-potential companies to list at the exchange.

Finally, one of the key pillars of every market is long-term institutional investors, including retirement funds, pension funds, endowments, and insurance companies. In Pakistan, the public sector employee retirement plans are, by and large, unfunded and on a pay-as-you-go basis. As a result, the participation of such long-term investors in capital markets is well below the desirable level. Even where such plans are funded, their focus is mainly on investment in government securities. As a result, they miss out on the Pakistani corporate sector's double-digit earnings growth and, in turn, on the higher returns offered by equities over the longer run (since its launch, the KSE-100 has returned approximately 15% per annum in Pakistani rupee terms). The next round of reforms could address this important area of the capital market.

The future offers several reasons to be optimistic about the Pakistani capital markets. New ownership at PSX can lead to technological and product innovation and facilitate cross-border listings in the future. An improved outlook for Pakistan's economy can attract sustained investor interest, particularly from the domestic retail market, which has significant room to grow. Investing in Pakistan offers access to the fifth largest population in the world (more than 200 million people), which leads to strong domestic consumption. Pakistan can attract foreign buying to its equities, similar to the foreign interest it has seen in its government bonds over the past year. However, more needs to be done to develop the corporate debt market, where a high fiscal deficit has traditionally crowded out the private sector. Fiscal discipline would have a positive impact. Notably, the government's Debt Management Office has taken several steps recently to develop the longer end of the yield curve, which should have positive implications going forward.