

## Brokerage Firms

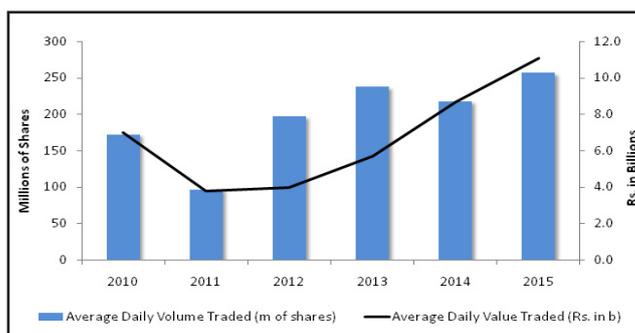
*Since the establishment of the Karachi Stock Exchange (KSE) in 1947, brokerage industry of Pakistan has steadily grown*

*Average daily turnover and daily value traded increased at a cumulative average growth rate (CAGR) of 6.8% and 8.0% respectively during 2010-15; volumes have not been promising in first two months of 2016 at 137.3m*

Brokerage firms play a key role in capital markets by serving as intermediaries through which investors can buy and sell shares on the stock exchange. Since the establishment of the Karachi Stock Exchange (KSE) in 1947, brokerage industry of Pakistan has steadily grown in line with development of capital markets and expansion of the economy.

Growth of the sector is sensitive to trading activity, as determined by two metrics namely average daily value traded<sup>1</sup> and average daily turnover<sup>2</sup>. As indicated in the graph below, the average daily turnover has increased since 2011, and was recorded at 258.8m (2014: 218.7m) during 2015.

Performance of Pakistan's stock market is measured by stock indices; primarily the KSE-100 index which was launched in 1991 with a base of 1,000 points. Typically, the index constitutes top 100 companies by



market capitalization<sup>3</sup> – the value of a firm's share price times the number of shares in free float – from highest to lowest. To ensure full representation, companies with the highest free float market capitalization from each sector are also included. Components of this index are weighted according to their overall market value. The index moves in line with price movement of stocks; a stock with a higher free float market capitalization would have a larger impact on the index's movement.

### Equity Market in 2015

While the index experienced volatility in the outgoing year, it has followed a bullish trend over past half-decade. In 2015, KSE-100 index rose by just 2.1% (2014: 27.2%) to reach 32,811 (2014: 32,131) points as at December 31, 2015. Generally, state of the economy is reflected in performance of the stock market. Furthermore, earning profile of a company has a direct bearing on performance of the company's stock. Economic stability has been maintained with GDP growth of 4.24% (FY14: 4.14%) during FY15. Further, market performance is influenced by trading activity of foreign investors which hold about one-third of free float shares. Despite foreign selling of USD 350m in CY15, the market has

<sup>1</sup> average daily value traded: average value of individual securities traded in a day or over a specified amount of time

<sup>2</sup> average daily turnover: number of shares of a security traded each day averaged over some period of time

<sup>3</sup> market capitalization: adjusted for free float

shown resilience on account of improving economic scenario and monetary easing by the central bank. Key determinants of market performance in 2015 are further detailed below.

### Positive Drivers

- 👍 Constant improvement in macroeconomic variables
- 👍 Successful reviews with the IMF
- 👍 Easing of monetary policy by SBP
- 👍 Improving law & order situation
- 👍 Successful secondary public offerings
- 👍 Falling yields on alternative fixed income avenues

### Negative Drivers

- 👎 Delays in privatization negatively affected investor sentiments
- 👎 Foreign outflows triggered by:
  - Expected devaluation of Pakistani Rupee
  - Slow-down in growth momentum of Chinese economy

### Industry Structure

As of June 30, 2015, 344 brokerage companies were operating in the country. The industry has a fragmented structure, with many firms operating on a small scale. Large players include AKD Securities Limited, JS Global Capital Limited, Pearl Securities Limited and Adam Securities. Granularity of the industry is considered low with four players commanding around 40% of the total market share<sup>4</sup>. In this fragmented market, players compete on the basis of low brokerage fees, timely market-related intelligence and trade execution service.

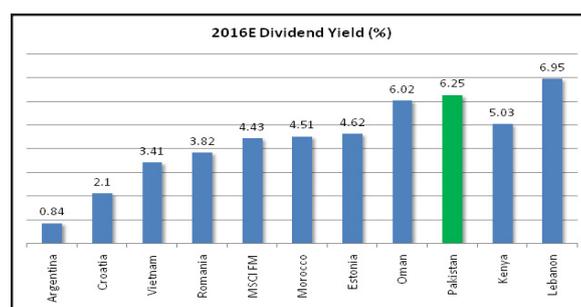
Brokerage companies primarily generate revenue by charging clients on trade execution. Typically, commission structure is variable with higher commission per share charged for higher priced shares. Average commission charged has demonstrated increase on a timeline basis to 5.1 paisa per share (FY14: 3.4; FY13: 2.9) during FY15<sup>5</sup>.

In a bid to diversify their revenue base, a number of companies (mainly large) have ventured into corporate finance and advisory business. This includes services pertaining to raising capital, mergers

	2012	2013	2014	2015
Total Listed Companies	590	569	557	560
Total Listed Capital (Rs. M)	1,069,838	1,116,005	1,160,341	1,189,519
Total Market Capitalization (Rs. M)	3,518,136	5,154,738	7,022,692	7,421,032
New Companies Listed	4	4	5	9
Listed Capital of New Companies (Rs. M)	11,861	7,404	19,235	38,140

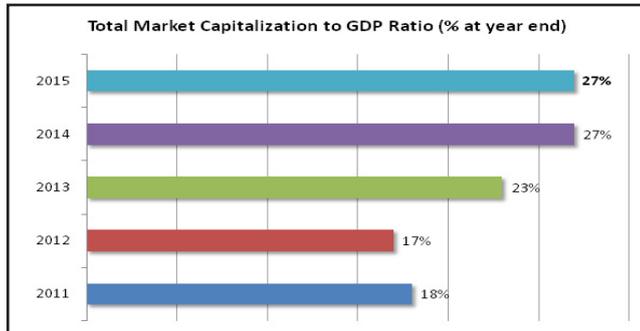
& acquisitions, privatization, balance sheet restructuring and financial advisory. Given the increase in initial public offerings and secondary share listings in 2015, a noticeable increase in underwriting and book building activities by brokerage firms has also been observed.

As valuation of a given market increases, brokerage firms earn greater commissions through trading of higher priced shares. The Pakistan Stock Exchange (PSX) currently trades at a trailing price to earnings ratio (PER)<sup>7</sup> of 9.6x. This indicates significant undervaluation vis-à-vis emerging & frontier market peers having a peer group average of 16.5x. Moreover, dividend yield<sup>8</sup> of Pakistan's stock market was 6.3% in 2015 which compares favorably with frontier markets as depicted in the adjacent figure.



<sup>4</sup> based on turnover; <sup>5</sup> average from a pool of 8 brokerage firms; <sup>6</sup> PSX Annual Report 2015; <sup>7</sup> trailing price to earnings ratio: price of a security per share at the present time divided by the trailing annual earnings per share for the previous year; <sup>8</sup> dividend yield: annual dividend per share divided by the price per share

Further, market capitalization to GDP ratio<sup>9</sup> of Pakistan increased from 18% in 2011 to 27% in 2015 as illustrated in the figure below. This increase is primarily driven by higher prices for existing stocks with contribution from listings of new companies being on the lower side. In comparison, India’s market capitalization to GDP was 68.4% while that for China was reported at 60% in the outgoing year.

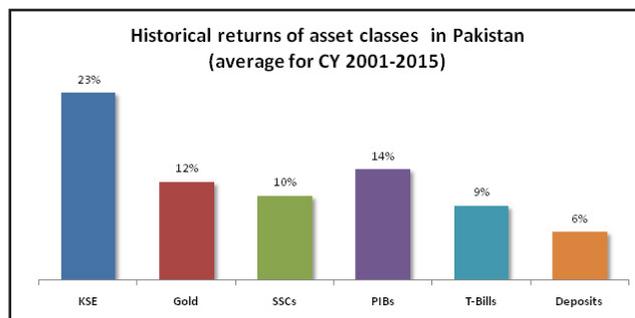


Brokerage industry is regulated by the Securities & Exchange Commission of Pakistan (SECP), PSX, National Clearing Company of Pakistan Limited (NCCPL) and Central Depository Company. During 2015, SECP took a number of regulatory steps through enforcement actions against brokers

along with issuance of warning letters and enquires against market participants. In order to increase awareness, a web-based investor education portal titled *jamapunji.pk*<sup>10</sup> was launched in 2015. As part of its ongoing efforts, the SECP reviewed legislation including Book Building Regulations, 2015, Research Analysts Regulations, 2015 and Securities Brokers Regulations, 2015. Additionally, the following draft documents are in process of being implemented:

- Access to Inside Information Regulations, 2016
- Underwriters Regulation, 2016
- Bankers to an issue of Securities Rules, 2016
- Guidelines for Preparation of Prospectus, 2016
- Credit Rating Companies Regulations, 2016

Client base of brokerage firms can be classified into two broad categories: institutions and individuals. Majority turnover in the market is generated by domestic institutions. Over past half-decade, a number of foreign investors have demonstrated significant growth. Asymmetric information, low bargaining power and increased focus on controls along with trading of higher priced shares by foreign clients has made commission charged to the same being more lucrative vis-à-vis domestic clients.



Despite the buoyant stock market, proportion of retail investors in Pakistan’s equity market remains strikingly low. Less than 1% of the population invests in securities, compared with approximately 10% in China and 18% in the United States of America. This is primarily attributed to lack of public awareness and a perception that Pakistan’s stock markets favors only big players.

<sup>9</sup> market capitalization to GDP: percentage of GDP that represents stock market value

<sup>10</sup> <http://www.jamapunji.pk>

STRENGTHS	OPPORTUNITIES
<ul style="list-style-type: none"> <li>• An integrated financial services platform</li> <li>• Unique, stable and scalable business model</li> <li>• Adoption of technology including online trading and KITS</li> </ul>	<ul style="list-style-type: none"> <li>• Structure of the industry, market size, and growth rates-significant potential in Pakistan market</li> <li>• Increased foreign inflows expected from CPEC</li> <li>• Potential for expansion of corporate base</li> <li>• Induction of PSX in the MSCI Emerging Market index may lead to greater trading activity along with increased levels of capitalization</li> </ul>
WEAKNESSES	THREATS
<ul style="list-style-type: none"> <li>• Weak compliance of regulatory regime</li> <li>• Lack of visible goodwill among minor players</li> <li>• Improvement in corporate governance needed</li> <li>• Significant key person risk in most companies</li> </ul>	<ul style="list-style-type: none"> <li>• High degree of competition</li> <li>• Volatile foreign investor base</li> <li>• Unresolved conflict of interest at most brokerage houses</li> </ul>

In January 2016, the KSE, Islamabad Stock Exchange and Lahore Stock Exchange were integrated into PSX. By enhancing the efficiency of capital markets, the integration is expected to support overall development of the brokerage sector. Given that all participants would trade through one exchange, liquidity in the market would increase. This would facilitate the government in successfully executing ongoing privatization deals earmarked to be done through listings. In the long term, an integrated stock exchange with brokers present throughout the country will act as a catalyst for increasing savings and channeling them into investments.

### Ranking of Pakistan among world's markets (based on annual return)

4th	10th	3rd	10th
2012	2013	2014	2015

### MSCI Reconstitution

Significant impetus to growth of the market is expected to result from reclassification of Pakistan in the Morgan Stanley Composite Indices (MSCI) Emerging Market (EM) Index. Global institutional investors use different MSCI – such as Frontier Markets (FM), EM, and Developed Markets to create balanced portfolios. Pakistan was first inducted in the MSCI EM index in February 1994. Following the market crash of 2008, trading was suspended for five months. As a result, Pakistan was reclassified from the EM to the standalone country index. In May 2009, MSCI made Pakistan part of the FM index. During the past year, the country has demonstrated a number of developments in terms of improving its market accessibility. These have included the following:

- Improvement in liquidity as indicated by rise in average daily volumes since 2011
- Launch of Pakistan Unified Corporate Action Reporting System (PUCARS) at the PSX
- Introduction of restrictions on Negotiated Deal Market (NDM) that aim to prevent unauthorized movement of client securities via NDM transactions
- Development of an online complaint management system

As per the MSCI Market Classification Framework, free float market capitalization of top 3 listed

<sup>11</sup> PUCARS provides a solution for posting the latest announcements of companies regarding financial status, directors' meetings, company news and others

companies has been a key constraint with regards to inclusion of Pakistan into the EM index. Over past half-decade, the same has crossed the required level of USD 630m. During Annual Market Classification review scheduled in June 2016, MSCI is considering incorporating Pakistan back into the index. In case of a favorable decision, actual reclassification will take place next year. However, given that global investors tend to factor in changes before actualization, sizeable inflows of global funds are expected.

### **Outlook**

The stock market has shown resilience despite continued foreign selling during 2015. Given the improved security situation and business sentiment in the country, investments are expected to pick up. Alongside, if PSX is inducted into the MSCI EM index, foreign institutional portfolio flows will be positive for share prices as well as foreign exchange reserves. Development under the ongoing China Pakistan Economic Corridor (CPEC) is anticipated to support sustained GDP growth. Low inflation and global oil prices, coupled with relatively safer external macro balances have provided room for the government to address structural problems. Along with economic growth, regulatory compliance and strong governance are identified as key determinants of the brokerage sector's prospects.

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