Pakistan Institute of Development Economics

Policy Brief

RASTA

DECAPITALIZATION IN THE PAKISTAN STOCK EXCHANGE

Abdul Wahid and M. Zubair Mumtaz

(CGP # 05-131)

(This document is unedited author's version submitted to RASTA)

INTRODUCTION

The Pakistan Stock Exchange (PSX) serves as a critical barometer of the country's economic health, facilitating the listing and trading of company shares. However, from 2010 to 2023, the PSX experienced significant decapitalization, marked by a net shortfall of 103 firms. Only 67 companies were newly listed during this period, while 170 were delisted. This alarming trend of delisting, whether voluntary or involuntary, underscores underlying economic, regulatory, and market challenges. The situation contrasts sharply with the Indian market, which saw a net increase of 1,315 companies, highlighting the need to understand the factors driving companies away from the PSX.

This study, funded by the 'Research for Social Transformation and Advancement' (RASTA) at the Pakistan Institute of Development Economics (PIDE), seeks to identify the firm-specific and market-related factors contributing to delisting in the PSX. By examining a sample of 60 delisted firms and comparing them with 60 firms that remained listed from both market, this research aims to provide actionable insights for policymakers to enhance market stability and attractiveness.

The significance of this study lies in its potential to inform policy decisions that can reverse the trend of decapitalization. A vibrant and growing stock market is essential for economic development, providing companies with access to capital, enhancing their visibility, and fostering investor confidence. Understanding why firms are choosing to delist is crucial for creating a more supportive regulatory environment and promoting sustained economic growth.

METHODOLOGY

This study targets all firms delisted from the Pakistan Stock Exchange (PSX) and National Stock Exchange (NSE) and Bombay Stock Exchange (BSE) from January 2010 to September 2023, as well as listed firms that remained on the exchange. Delisting is categorized as either voluntary or involuntary, with this research focusing specifically on voluntary delisting decisions. The sample includes 60 delisted firms and 60 matching firms from the PSX, selected based on market capitalization. Data were collected for the three years preceding each firm's delisting to ensure comprehensive analysis. For example, if a firm was delisted in 2013, data from 2010 to 2013 were used. Financial data were sourced from firms' financial reports, while governance-related information was obtained from these reports and the firms' websites. This approach ensured a robust and accurate dataset for analysis.

The Cox Proportional Hazards Model was employed to determine the factors influencing delisting. This model allows for the examination of the relationship between the survival time of firms (time until delisting) and a set of explanatory variables, including firm’s specific and market relate factors to provide a comprehensive view of the determinants.

FINDINGS

Global Listing Trends

The global listing trends reveal a significant decline in the number of listed firms in South Asia and other major markets. From 2000 to 2020, South Asia experienced a decrease in listed companies from 6633 to 6329, indicating a higher delisting rate compared to new listings. Similarly, the number of listed firms in the United States decreased from 5860 in the 2000s to less than 4400. These trends suggest that various factors, including rising interest rates, the financial crisis of 2007-08, and shifts in investor preferences towards markets offering higher returns, have contributed to the decline in equity markets globally.

Capital Erosion at PSX

PSX experienced significant capital erosion from 2010 to 2023, with a net listing shortfall of 103 companies. Despite reaching an index level of over 72,000 points, the PSX faced a delisting trend, particularly during domestic crises such as the energy crisis and security issues. The firms most affected by delisting included textile spinning, textile composite, exchange-traded funds, and investment banks. Capital inflows and outflows fluctuated during this period, with certain years experiencing higher decapitalization.

Determinants of Delisting at PSX

Our study utilized the Cox Proportional Hazards model to identify key factors influencing a firm's decision to voluntarily delist from the stock market, focusing on financial, firm-specific, and governance-related aspects. The analysis revealed critical financial performance indicators such as Earnings Per Share, Price-Earnings Ratio, Dividend Payout Ratio, and Profit Margin, with corresponding hazard ratios suggesting that superior financial metrics decrease the likelihood of a firm going private. Additionally, firm-specific factors like liquidity, growth, and financial management practices significantly impact this decision. For example, higher revenue and profit growth rates decrease the propensity to delist, while high debt levels and increased operational costs like audit and listing fees increase it.

The study also highlights the influence of corporate governance and market dynamics on delisting decisions. Larger, well-established firms with diverse boards are less likely to delist, whereas higher insider ownership and bureaucratic complexities in state-owned enterprises increase the likelihood. Moreover, market volatility and regulatory challenges further complicate the stability and operational environment for firms, influencing their decision to remain public or go private.

These findings underscore the complex interplay of financial performance, firm characteristics, and external market and governance factors in shaping corporate strategies in the stock market.

KSE 100 Index Constituents and Financial Visibility

Our analysis of the KSE 100 index as of June 2024 reveals a dynamic composition, with a notable concentration of influence among the top firms. The index's weight is distributed such that the top six companies constitute 25%, the next seven firms another 25%, and 19 companies make up the third quartile (50%-75%). The remaining 68 companies account for the final 25% of the index weight. The net profit margins and dividend payout ratios across these quartiles vary, highlighting both remarkable progress and financial challenges in different sectors. This data has led us to

further investigate the top five sectors with the highest index weightage to understand their impact on the overall market.

Oligopoly of Rent-Seekers

The banking sector, leading the KSE 100 Index with a 19% weight, showcases a 28.73% dividend payout and a 13.42% profit margin, fueled by high policy rates and monopolistic practices that restrict new entries, enhancing its market value. Following, the Oil & Gas sector commands 10.56% of the index, benefiting from state ownership and rising fuel prices, resulting in a 32.35% profit margin and a 36.75% payout ratio.

The Fertilizer sector, essential for agriculture, holds a market monopoly supported by energy subsidies, showing a 12.99% profit margin and a 43.50% payout ratio. The Power Generation & Distribution sector operates under a monopolistic regime, earning capacity charges and maintaining profitability with a near 100% asset utilization ratio despite high electricity bills.

Lastly, the Technology & Communication sector, comprising 8% of the index, thrives on a monopoly with five companies, driven by a youthful, tech-oriented demographic, resulting in robust profits and a 36.00% payout ratio.

Top Delisted Sectors

The top sectors experiencing higher delisting rates include Textile Spinning, Textile Composite, Exchange Traded Funds, and Investment Banks. Sector-specific factors such as Earnings Per Share (EPS), Price-Earnings Ratio (PER), and firm size significantly influence the likelihood of delisting. The findings indicate that financial performance and market conditions within these sectors play a critical role in firms' decisions to delist from the PSX.

Determinants of Delisting Indian Market

In the Indian market, similar factors influence delisting decisions, but with notable differences. The Indian stock exchanges (NSE and BSE) saw a net increase in listings, attributed to more favorable regulatory policies and better financial visibility for smaller firms. Key determinants of delisting in the Indian market include: (a) Indian exchanges have less stringent regulatory requirements compared to the PSX, making it easier for firms to remain listed, (b) the Indian market offers higher financial visibility and better growth opportunities for smaller firms, reducing the likelihood of delisting and (c) Similar to Pakistan, sectors like textiles and finance are significantly influenced by market conditions and financial performance, but Indian firms benefit from a more supportive regulatory environment.

DISCUSSION & CONCLUSION

The decapitalization of the PSX, characterized by a net listing shortfall, poses significant challenges to Pakistan's economic growth and market stability. The study identifies multiple determinants influencing delisting decisions, ranging from financial performance and corporate governance to market dynamics and sector-specific factors. Discussions with SECP and PSX officials, along with brokers, investors, and firm managers, reveal that regulatory complexities increase the costs and duration of listing and compliance, challenging transparency efforts in financially opaque environments.

Effective firms attract investors with high net profit and payout ratios, but many struggle due to inflation and limited consumer spending. Competitive returns on sukuk and sovereign bonds

disadvantage smaller, lesser-known companies, with only well-supported and large entities thriving. Market volatility and governance issues, particularly in SOEs and family-run firms, further push companies towards privatization, influencing market stability and policy.

These insights are crucial for policymakers and regulatory bodies like the SECP to develop strategies that enhance the financial stability and visibility of listed firms.

KEY POLICY RECOMMENDATIONS

1. Reduce compliance costs and streamline regulatory procedures to make listing and maintaining a listing more attractive for firms.
2. Ensure that all sectors receive equal support in terms of incentives and tax rebates to foster balanced growth.
3. Promote robust corporate governance practices, including increasing non-executive directors and ensuring diverse boards.
4. Enhance financial visibility through accurate and timely disclosure of financial information and performance metrics.
5. Implement measures to reduce the influence of specific families and bureaucrats in policy-making, fostering a competitive market environment.