

VIS

Credit Rating Company Limited

BROKERAGE AND SECURITIES SECTOR REPORT

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INTRODUCTION

A brokerage company primarily acts as a middleman, connecting buyers and sellers to facilitate a transaction on behalf of an individual, business or organization for a commission or agreed fee. Many businesses and individuals perform high-risk and high-volume financial transactions regularly but lack the industry knowledge to execute them comfortably. As a result, they engage brokerage and Securities firms to handle these asset transactions diligently using specialist platforms and contacts. They act as an intermediary between investors and securities exchanges who only accept orders from licensed brokers and traders. Whilst there could be numerous types of brokerage companies from stock broker to real estate brokers to insurance brokers to commodity brokers, this report however deals with the brokerage and securities sector which facilitates trading and investing in financial securities such as stocks, bonds, derivatives and other financial assets in the primary market (new issues) as well as the secondary markets (exchanges). In this context the main function of a brokerage and securities company is to:

- Execute trades in the financial markets at the expense of the customer and on his behalf.
- Provide information support about the situation on trading platforms, sending notifications about quotes and trading mechanisms.
- Provide information about other market participants, making the correct decision for the client to conduct the transaction
- Lending to clients for margin transactions
- Storage and protection of customer data.
- Custody of Securities
- Creating a technical base to make transactions on the exchange.

Nowadays mainly there are two types of brokerage firms:

Full-service broker also known as traditional brokerages provide a wide range of products and professional services including money management, tax advisory, investment advisory, equity researching, etc. These companies also offer stock quotes, research on economic conditions, and market analysis. Highly trained and credentialed professional brokers and financial advisers are available to advise their clients on money matters. In addition to trading services large brokerage and securities firms also provide underwriting and financing facilities. Merrill Lynch Wealth Management, Morgan Stanley, and Edward Jones are among the big names in full-service brokerages.

Online broker is a new form of digital investment that interacts with the customer on the internet. Online brokerages offer the main advantages of speed, availability, and low commissions.

Brokerage and securities firms are not Asset Management Companies (AMCs). AMCs actively manage investments while brokerages facilitate the buying and selling of securities for clients. AMCs earn fees based on assets under management, brokerages earn commissions and fees from trading volumes and securities lending. AMCs are subject to regulations on fiduciary duty to clients, brokerages have less stringent suitability standards and conflicts of interest. But there is some overlap as well. Many firms offer both brokerage and asset management services. The biggest AMCs like BlackRock and Vanguard oversee trillions dollars in assets. The biggest brokerages like Charles Schwab have billions dollars in client assets.

ECONOMIC OVERVIEW

The geopolitical situation, difficult financial environment, and high inflationary pressures have all had a substantial impact on the prospects for global growth. All these factors posed significant economic risks for Pakistan's economy as well. In FY2022, Pakistan's economy witnessed a high growth rate of 6.1 percent, however, owing to the severe macroeconomic imbalances, flood damages, domestic supply shocks, and international economic slowdown have dampened the economic growth to just 0.29 percent in FY2023. On the international front, the prolonged Russia-Ukraine conflict adversely affected global growth and inflation remained unexpectedly high.

Capital Markets are an important and integral part of economy and benefit it by encouraging the efficient allocation of risk among participants in a competitive environment. Capital markets play a pivotal role in mobilizing domestic resources and channeling them efficiently for productive uses, thus raising country's productivity as well as provides access to foreign capital for domestic economy, thus, plays a key role in overall development of a country. Brokerage and Securities firms along with trading platforms such as stock exchanges are the main driver of the capital markets.

GLOBAL PERSPECTIVE

The securities brokerage and stock exchange services market consist of revenues earned by entities by acting as brokers in selling securities such as equities, bonds, commodities and derivatives. Securities brokerages represent customers in dealing with securities transactions on the trading floor/online platform of stock exchanges.

The global securities brokerage and stock exchange services market grew from USD1696.91 billion in 2022 to USD1844.31 billion in 2023 at a compound annual growth rate (CAGR) of 8.7%. The securities brokerage and stock exchange services market is expected to grow to USD2506.41 billion in 2027 at a CAGR of 8.0%. North America was the largest region in the securities brokerage and stock exchange services in 2022 followed by Asia Pacific region and Europe. The Securities Brokerages and Stock Exchanges market in the U.S. is estimated at USD370.8 Billion in the year 2022. China, the world's second largest economy, is forecast to reach a projected market size of USD327 Billion by the year 2030 trailing a CAGR of 6.3% Within Europe, Germany is forecast to grow at approximately 3.2% CAGR. While Vanguard, Charles Schwab, Fidelity Investments, JPMorgan Chase and Merrill Lynch are the largest brokerage firms in terms of assets under management, a list of the to 10 largest stock exchanges is as follows:

| WORLD LARGEST BROKERAGE FIRMS | |
|-------------------------------|---|
| Stock Brokerage Firm | Assets Under Management USD Billion (As of August 2023) |
| Vanguard Group | 8,200 |
| Charles Schwab | 8,020 |
| Fidelity Investments | 4,500 |
| JP Morgan Chase | 3,900 |
| Merrill Lynch/Bank of America | 3,600 |

| WORLD LARGEST STOCK EXCHANGES | |
|--------------------------------|---|
| Stock Exchange | Assets Under Management USD Billion (As of August 2023) |
| New York Stock Exchange, USA | 24.3 |
| NASDAQ, USA | 20.13 |
| Shanghai Stock Exchange, China | 6.93 |
| Euronext | 6.42 |
| Japan Stock Exchange | 5.63 |
| Shenzan Stock Exchange, China | 4.67 |
| Hong Kong Exchanges | 4.19 |
| National Stock Exchange, India | 3.26 |
| LSE Group UK | 3.1 |
| Saudi Stock Exchange | 2.83 |

Increasing popularity of online trading platforms is one of the prime reasons driving the securities brokerage and stock exchange services market growth. Also, rising adoption of robo-advisors for managing investment portfolios for investors and increasing adoption of new online apps for trading and investing will lead to sizable demand in the market.

Securities brokerage companies are extensively using artificial intelligence (AI) for faster trade executions. Artificial intelligence refers to programming machines to enable them to work and react like humans. Most companies are using AI for algorithmic trading in stock brokerage. Algorithmic trading refers to turning a trading idea into an algorithmic trading strategy using an algorithm. The AI-enabled alternative trading system (ATS) helps in improving the speed of trade execution. For instance, some of the major trading houses, like Blackrock, Two Sigma, and Renaissance Technologies, are using AI in the selection of stocks to be purchased.

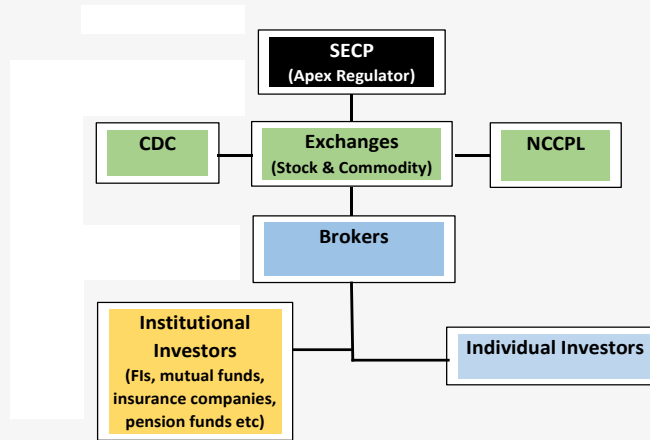
Brokerages are cross-selling and upselling products and services to further increase their revenues. Cross-selling and upselling is a technique aimed at capturing a larger portion of the client's assets. In addition, bank brokers across the world are focusing on aggregating information related to client accounts and lowering their fees to serve affluent investors. This allows bank brokers to cross-sell their online trading and advisory-based services to affluent investors who hold multiple accounts with retail banks and bank brokers.

Also, Brokerage firms are increasingly focusing on providing additional peripheral services to their customers around the world. Ad hoc peripheral services are unconventional trading solutions such as investment advice and planning services offered by brokerage firms to attract more customers. This is mainly to remain competitive in a price-sensitive market and capture a larger portion of the investor's assets. For instance, firms are offering loyalty programs, retirement products and services, analytical software, and social components to increase their share in the market.

Globally, the sector has consolidated amidst increased automation and regulation. Trading volumes have risen steadily, driven by retail investing. However, fee compression and thin margins remain an ongoing challenge. Cybersecurity threats are also a growing concern. The outlook is cautiously optimistic given forecasted growth in assets under management. The brokerage sector outlook remains positive globally driven by demand growth for investing. However, fee pressures, regulations, digital disruption, competition will continue posing challenges.

PAKISTAN BROKERAGE & SECURITIES MARKET

The capital market structure in Pakistan consists of the apex regulator of the markets, the Securities and Exchange Commission Pakistan (SECP), Pakistan Stock Exchange, Mercantile Exchanges, Central Depository Company (CDC) and a Clearing and Settlement Company (NCCPL). The structure further includes intermediaries or market participants such as Brokers who handle the transaction of shares in the capital markets on behalf of investors.



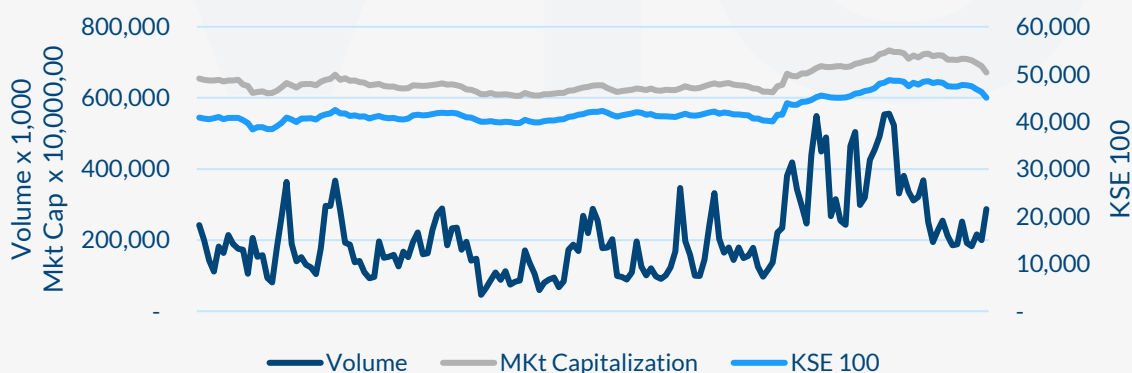
SECURITIES MARKET

Performance of the Brokerage & Securities firms is largely correlated with performance of the stock exchanges. In 2016 the previous three exchanges namely Karachi Stock Exchange, Lahore Stock Exchange and Islamabad Stock Exchange were merged and demutualized with a consortium of Chinese investors taking a strategic holding (30%) and two local institutions (10%). The merged entity was named as Pakistan stock Exchange (PSX). PSX primarily facilitates share trading however it also provides platforms for trading in debt securities and derivatives.

Equity Market

Equity Market, usually known as Stock Market, is the marketplace where general public can invest, buy and sell shares of the companies listed. Currently, there are more than 523 companies listed on Pakistan Stock Exchange with a Market Capitalization of more than Rs 6 Trillion as September 2023. Of these 523 listed companies about 100 are regularly active. Overall, market capitalization was USD 22.650 billion as of September 19, 2023 with free float component (by market value) of 27.25% or USD 6.172 billion. Top 10 companies accounted for approximately 32% of market turnover and 26 companies (Top 10 traded companies in any month during Jan-Aug. 2023) were responsible for about 41% of the turnover.

PSX PERFORMANCE DAILY JANUARY - AUGUST 2023



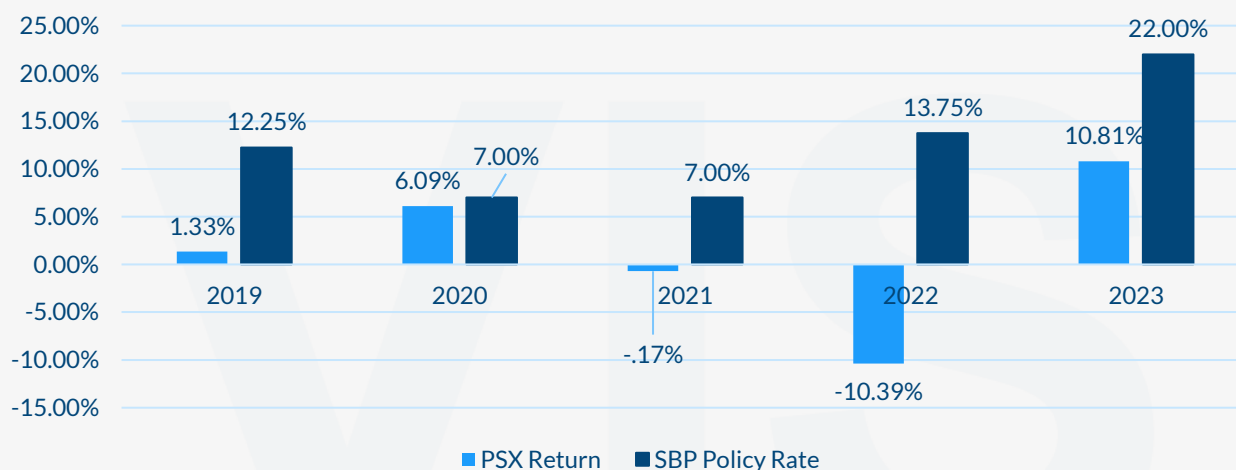
The listed companies are distributed amongst more than 35 sectors or groups of industries and nine sub markets including;

- Regular/ Ready market - In this market segment, stocks of all companies listed are traded. Transactions are settled in two days (T+2);
- Odd lot market - In this market segment, investors can trade in securities in lots which are less than normal/ regular lots (500 shares). The minimum number of shares that can be traded is 1. Settlement takes place in T+2 days;
- Small & medium enterprise market - Here shares of companies with post-issue paid-up capital between 25 Mn and 200 Mn PKR are traded. Target investors for this segment include Qualified Institutional Buyers (QIBs) and High Net Worth Individuals (HNWI); Square up market -In this market segment, if a Clearing Member (CM) fails to deliver sold securities, then the failed deliveries are squared up in the Square-up Market;
- Negotiated deal market - This is not part of the mainstream market transactions. Here negotiated deals are conducted outside the Exchange Trading Systems and are reported through the interface provided by the Exchange. These deals may also be called Off Market Transactions. These transactions are conducted between brokers;
- REIT (Real Estate Investment Trust) -REIT is a fund based trust that owns income-producing real estate, buys real estate, develops, manage/ operates and sells real estate assets. REITs are modelled after mutual funds where all taxable income is paid out as dividends to shareholders.

PSX Returns

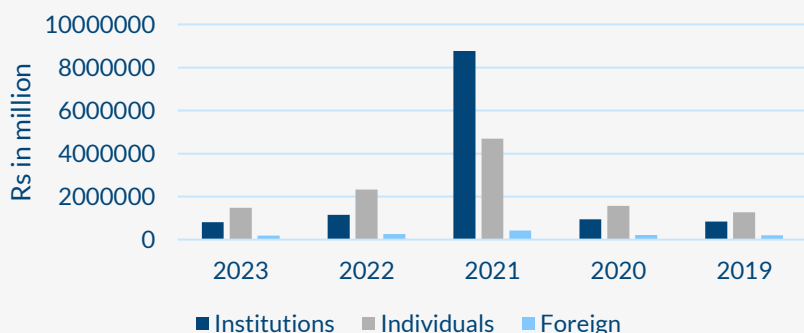
Due to declining returns on investment on share trading investment in equities has fallen over the years. Difficult economic conditions have also contributed to decline in investment, particularly, foreign investment.

PSX Returns vs SBP Policy Rate



| PSX SHARE TRADING DATA | | | | | |
|------------------------|--------|--------|---------|--------|--------|
| All Shares | 2023 | 2022 | 2021 | 2020 | 2019 |
| Volume (Million) | 34,660 | 56,884 | 117,062 | 82,753 | 39,275 |
| Value (Rs in Billion) | 1,185 | 1,723 | 4,183 | 3,080 | 1,458 |

CATEGORY-WISE INVESTMENT IN PSX



FOREIGN INVESTMENT IN PSX



Fixed Income Securities Market

Fixed income securities include Corporate Debt securities/ bonds and Government Debt securities/ bonds. These bonds are investment products that provide a return in the form of fixed periodic payments as mark-up and the eventual return of principal. Any investor can purchase these securities listed at the Stock Exchange through authorized participants. The Fixed Income products listed at the PSX are:

Corporate debt instruments

These include Term Finance Certificates (TFCs), Sukuk Certificates, Registered Bonds, Corporate Bonds etc., and all kinds of debt instruments issued by any Pakistani company or corporation registered in Pakistan. During July-March FY2023, twenty debt securities were reported and their break-up is as under:

| DEBT SECURITIES | | | |
|-----------------|---|---------------|---------------------|
| S.No. | Type of Security | No. of Issues | Amount (Rs billion) |
| 1. | Privately Placed Term Finance Certificate | 4 | 24.5 |
| 2. | Privately Placed Sukuk | 14 | 68.5 |
| 3. | Privately Placed commercial Papers | 2 | 6.0 |
| | Total | 20 | 99.0 |

Source: Economic Survey of Pakistan 2022-23

| CORPORATE DEBT SECURITIES (OUTSTANDING) As of March 2023 | | | |
|--|----------------------------------|---------------|---------------------|
| S.No. | Name of Security | No. of Issues | Amount (Rs billion) |
| 1. | Term Finance Certificates (TFCs) | 62 | 206.8 |
| 2. | Sukuk | 52 | 613.7 |
| 3. | Commercial Papers | 3 | 6.1 |
| | Total | 117 | 826.6 |

Source: Economic Survey of Pakistan 2022-23

Government debt instruments

These are debt instruments issued by the Government of Pakistan. These include PIBs, Treasury Bills, National Savings Bonds, and Islamic Ijarah Sukuks.

Derivatives Market

A derivative is a financial security with a price that is dependent upon or derived from one or more underlying assets. The most common underlying assets include stocks, bonds, commodities, currencies etc. Derivatives can be used for the purposes of speculation, hedging, or for accessing hard-to-trade assets or markets. The types of Derivatives traded on PSX are:

Deliverable Future Contracts (DFC)

DFCs are standardized futures contracts to buy or sell eligible underlying securities with actual delivery of the said security occurring at the expiry of the contract. The minimum lot for trading in DFC is 1 contract that consists of standard 500 shares of underlying security. Contract maturity is 90 days after the contract is listed.

Single Stock Cash Settled Futures (CSF)

It is a standardized contract which allows buying or selling of eligible underlying shares at a certain date in the future, at futures price i.e., the price on which it is bought or sold in the CSF market. It is settled in cash, where the result of the settlement is the cash difference between the futures price and final settlement price. The minimum lot for trading in CSF is one contract that provides exposure of standard 500 shares of underlying shares. Contract maturity is 90 days after the contract is listed.

Stock Index Futures Contract (SIFC)

SIFC is a standardized contract which allows buying or selling a standardized value of the underlying stock index on a future date at a futures price i.e., the price at which it is bought or sold in the SIFC market. SIFC gives an opportunity to investors to trade in the relevant market by buying index futures with related underlying index instead of buying index's individual securities. Contract maturity is 90 days. The Indices on which SIFCs are currently available at PSX are KSE-30 Index, Oil and Gas Tradable Sector Index (OGTI) and Banking Sector Tradable Index (BKTI)

Options

PSX is currently working on the development of stock derivative Options.

Other than equity market, trading in debt and other securities is very low to negligible.

LOW PENETRATION

Pakistan ranks poorly on financial inclusion rankings. In terms of number of retail investor accounts, Pakistan has the lowest number as compared to other regional countries including India, Malaysia, Bangladesh and even Sri Lanka, which has almost one tenth of Pakistan population. Some of the other reasons for low retail participation are (i) Lack of access of investors to stock brokers and (ii) lack of financial literacy and investor awareness to alternative sources of savings and (iii) lack of trust of retail investors due to frequent cases of broker default (iv) alternative informal markets and asset classes such as real estate, National Saving Schemes (NSS) and gold which have less onerous tax and KYC requirements.

COMPETITIVE/REGULATORY LANDSCAPE

Brokerage and securities is a highly competitive industry, with over 200 brokerage firms licensed by the Securities and Exchange Commission of Pakistan. Out of these, only 20 have Entity Ratings and 19 have Broker Management Ratings, with just few listed on the Pakistan Stock Exchange. However to promote efficiency in the capital market through transition to single rating regime, the rating requirements for brokers has been simplified by abolishing Broker Management Rating and prescribing the minimum Broker Fiduciary Ratings for Trading and Clearing Brokers and for Trading and Self-Clearing Brokers. Leading brokerage and securities companies in Pakistan are Arif Habib Limited, AKD Securities, JS Global Capital, BMA Capital and KASB Securities Limited. Their performance during 2019-22 is summarized as under:

Online/electronic trading is gaining momentum benefitting low-cost online firms like AKD Trade and Next Capital. Retail participation remains low compared to other emerging markets, but new mobile trading apps are increasing access. The sector remains lightly regulated compared to global peers. Minimum capital requirements are low leaving room for new entrants. Securities lending and short selling activity are negligible in Pakistan. Regulators are hesitant to permit short selling due to volatility concerns. Related party trading and circular trading are key regulatory concerns around manipulation and fairness. Improved surveillance systems are a priority. Financial markets remain shallow in Pakistan, limiting hedging tools for brokerages to manage risk. Almost all trades are focused on equities.

| Rs in Million | 2022 | | | | 2021 | | | |
|---------------|-------|-----------|-------|--------|-------|-----------|-------|-------|
| | AHL | JS Global | BMA | AKD | AHL | JS Global | BMA | AKD |
| Investments | 5,003 | 734 | 530 | 3,736 | 4,852 | 1,578 | 379 | 1,578 |
| Total Assets | 8,172 | 5,357 | 2,738 | 11,163 | 8,472 | 6,591 | 3,775 | 6,591 |
| Revenue | 1,184 | 754 | 599 | 1,075 | 3,078 | 1,167 | 950 | 1,167 |
| Rating | AA- | AA | A- | AA- | AA- | AA | A- | AA |

| Rs in Million | 2020 | | | | 2019 | | | |
|---------------|-------|-----------|-------|-------|-------|-----------|-------|-------|
| | AHL | JS Global | BMA | AKD | AHL | JS Global | BMA | AKD |
| Investments | 5,529 | 476 | 253 | 476 | 4,291 | 649 | 270 | 649 |
| Total Assets | 6,869 | 5,391 | 2,359 | 5,391 | 5,642 | 4,092 | 1,721 | 4,092 |
| Revenue | 707 | 727 | 508 | 727 | 480 | 527 | 358 | 527 |
| Rating | AA- | AA | A- | AA | AA- | AA | A- | AA |

SECTOR DYNAMICS

The brokerage and securities sector has undergone significant changes in recent years driven by technological advances and evolving investor preferences. Key success factors are scale, low costs, technology, and brand reputation. Larger firms leverage scale advantages however small niche players can thrive by specializing in profitable segments. Consolidation in the sector is driven by need for investments in compliance, cybersecurity, and automation. Online and discount brokerages have taken substantial market share from traditional full-service firms by offering low-cost trading platforms and minimal research. However, full-service firms maintain dominance in providing personalized advice and access to initial public offerings. The rise of passive investing and exchange-traded funds has also impacted the sector. High-frequency trading now accounts for substantial part of all trades, creating fierce competition for trade execution speed. Overall, the sector is adapting to greater automation, lower fees, and diversification of services to meet changing investor needs. Demographic shifts and wealth transfers between generations are also leading to new market entrants.

Firms that build trusted relationships and harness technology to improve efficiencies are well-positioned to thrive in the evolving competitive landscape.

SECTOR ISSUES

LOW RETAIL INVESTOR PARTICIPATION

The equity market in Pakistan is still at a nascent stage with very few retail investors actively trading and investing in the stock market. This limits the growth potential of local brokerage houses. Generational shift and competition from new business models is another challenge for brokerage firms.

LIMITED FINANCIAL PRODUCTS

Brokerage firms in Pakistan have limited securities offerings beyond basic stocks and bonds. More complex products like derivatives, commodities, and securitized assets are still not common. This restricts revenue sources for these firms.

TECHNOLOGICAL INFRASTRUCTURE

Many local brokerages have inadequate investing platforms and lack sophistication in terms of trading tools, analytics, and customer service. This hampers their ability to cater to investor needs. Cybersecurity risks from growing digitalization and online access is also a serious risk.

REGULATORY RESTRICTIONS

Strict regulatory requirements like higher capital adequacy ratios, compliance issues, and control on leveraged products impede the development of brokerage firms. The regulatory framework needs further evolution.

CORPORATE GOVERNANCE AND TRANSPARENCY

Opaque structure of some family-owned brokerages raises concerns about insider trading, which along with low financial disclosure levels remain key issues. This affects investor trust and confidence as well add to the cost.

HUMAN CAPITAL

Shortage of skilled financial analysts and investment advisors in the country remains a talent constraint. This impacts service quality and product innovation.

ACCESS TO CAPITAL

Many smaller brokerage firms have limited access to growth capital for expanding operations and offerings. Lack of funding impedes their competitiveness.

SECTOR OUTLOOK

While the brokerage and securities sector in Pakistan faces some persistent challenges, the future outlook appears positive given the country's demographics and untapped growth potential. Rising middle class income, high youth population, increasing financial literacy and digital adoption are expected to boost investor participation over time. To capitalize, regulators need to introduce further reforms, innovation and global integration of the capital markets.

Allowing market consolidation, easing foreign entrant restrictions and facilitating introduction of new can aid growth. Overall, the brokerage sector remains profitable though faces margin compression from competition and regulations. Continued growth in assets under management provides optimism, but cyber risks necessitate large technology investments. Overall the sector is stable with a mildly positive outlook.

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