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A Giant Awakens


MCB has been attracting deserved rations of admiration for being the first Bank in Pakistan to be listed on the London Stock Exchange for issuing US\$ 150 million worth of Global Depository Receipts (GDR).

This issue examines the impact of Global Depository Receipts on the economy, while tracing the motivation for the issuing company to issue GDRs and the investors to purchase them. Taking the GDR launch of MCB as a case in point, it looks into the complementary nature of privatization and issuance of GDR.

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Leading in Style!

MCB has been attracting deserved rations of admiration for being the first Bank in Pakistan to be listed on the London Stock Exchange for issuing Global Depository Receipt (GDR). The current size of MCB's GDR is US\$ 150mn. The GDR constituting four ordinary shares is priced at Rs 1,056 (US\$ 17.4) or Rs 264 per share.

Tracing the origin

Followed by the GDR issue of PTCL in September 1994, HUBCO in October 1994 and Chakwal Cement in April 1995, MCB is the fourth company and the first bank in Pakistan to launch GDR after eleven years.


The idea of depository receipts has developed significantly in the last few years. Defined as a transferable financial security, depository receipts though traded on a local stock exchange represent equities issued by a foreign publicly listed company. American Depository Receipt (ADR) normally traded on the US national stock exchange represents the most common form of Depository Receipts. Since the inception of ADRs in the 1920s, the depository receipts have spread over the world in the form of Global Depository Receipts (GDR), European DRs and International DRs.

Permitting foreign investors to buy shares in the equities of a foreign country, a GDR can access two or more markets, usually Euromarkets as an EDR and the US as an ADR.

Going Global! What it takes?

The GDR is issued when a foreign company intends to list its already publicly traded shares or debt securities on a foreign stock exchange. However, before the concerned company can have its listing on a particular stock exchange, it has to meet the prerequisites set forth by that exchange. The following example of how a GDR is created and traded clarifies the workings of GDR in detail:

Consider a company in Pakistan that intends to list its publicly traded shares on London Stock Exchange in the form of a GDR. As mentioned earlier, it is most important for the company to meet the requirements for DR listing of the London Stock Exchange. Next, a British broker via a local brokerage house or an international office in Pakistan would acquire the domestic shares from the market in Pakistan, before the shares of the company can be traded freely on the exchange. Once this has been accomplished, the broker will have the shares delivered to the local (Pakistani) custodian bank of the depository bank. The depository bank is the British organization issuing the GDRs in the United Kingdom. In this scenario, the depository bank is the Deutsche Bank whose local custodian bank in Pakistan receives the shares.



On receiving these shares, this custodian bank authenticates the delivery of the shares by informing the Deutsche Bank that the shares can now be issued in the United Kingdom. The Deutsche Bank then delivers the GDRs to the broker who initially acquired them. On the basis of an already determined GDR ratio, each GDR issued represents one or more of the Pakistani local shares and the price of each GDR would be issued in either U.S. dollars or Euros converted from the corresponding rupee price of the shares being held by the depository bank. The GDRs now represent the local Pakistani shares held by the depository, and can now be freely traded on the London Stock Exchange among investors through intra-market trading. These transactions are settled like any other British transaction on the London Stock Exchange. The investor is conferred similar privileges of shareholders of ordinary shares including the voting rights, cash dividends and bonus issues. The GDR certificate states the rights of its holders clearly.

No room for divergence

Assets with similar characteristics or an identical asset trading in two separate markets, must sell at the same price in an efficient market. If this is not the case, then a price differential may trigger a risk free profitable prospect to purchase the asset from the market where it is under priced and sell it where it is overpriced. This opens door to arbitrageurs. However, restrictions on the capital account may reduce options for these arbitrageurs. For example in case of MCB's GDR, no arbitrage opportunity exists as these GDRs are non convertible and issuance of fresh GDRs is restricted. In contrast, in absence of these restrictions arbitrage opportunities could be availed. This consequently triggers a realignment of the prices, causing the GDR prices to converge to equilibrium level.

Investors look forward to any such occasion where they would be able to earn risk free return on their investments. As mentioned earlier a price differential makes room for arbitrage opportunity. For instance, in the above scenario, the investor shall compare the U.S. dollar price of the GDR of the respective company with the U.S. dollar corresponding price of the local share on the Pakistani market. If the GDR of the Pakistani company is trading at US\$ 18 per share while the share trading on the domestic market is valued at US\$ 17 (post conversion from rupee to dollars), the investor would tend to buy more local shares from Pakistan and issue GDR on the British market. This will cause the price of the local Pakistani share and that of the GDR to converge to the same level. Consequently, this constant trading between GDRs and local shares tends to keep the prices of the two close to each other. However, it is important to note that since GDRs are denominated in foreign currency, and there exist time lags and transaction costs, a petite opportunity for arbitrage is usually present.



GDR Blessings

Increasing Liquidity

GDRs tend to increase the liquidity of the concerned company by simplifying the process of buying and selling the asset (GDR in this case) quickly with relatively small price changes. Increased liquidity fundamentally means that a liquid market for a security must have depth and breadth, and support speedy price discovery. A liquid market is said to have depth if buy and sell orders exist both above and below the prices at which a GDR is transacting. Similarly, the market is said to have breadth if buy and sell orders exist in good volume.

Bowing on the global stage

As the name in itself suggests, GDRs tend to enhance global trade that augments volumes on local and foreign markets. Additionally, it increases the flow of information and technology while ascertaining regulatory procedures and market transparency. This essentially means that since GDRs are listed on foreign stock exchanges, the concerned company has to meet the prerequisites set forth by that exchange and this shall ensure transparency.

For the company issuing the GDR, it is an opportunity to raise capital in the world market and hence gain greater exposure and enhanced esteem for being traded globally. Additionally, these receipts promote an international shareholder base and provide simple means to emigrants to invest in their home countries. It is important to note that in emerging markets like ours, foreign investors are often prevented from entering the local market due to several hurdles present. However, issuing GDRs allows the company to promote foreign investment without being concerned about these barriers to entry.

On the other hand for the investor, investing in GDRs converts the investor's portfolio without more ado into a global one. Investing directly into the foreign markets makes the investor's portfolio vulnerable to varying regulatory procedures causing instability and lack of transparency. However, with GDRs the investors acquire the privileges of diversification in their portfolio and they are hedged from the additional risk of investing in the foreign markets while gaining the advantage of these higher risks and higher returns equities. Moreover, the investors are also at a psychological ease as they are trading in their own market under familiar settlement and clearance conditions.

Promoting Mergers and Acquisitions

Endorsing Mergers and Acquisitions by smoothing the trading and settlement concerned with Merger and Acquisition transactions, GDRs through payment of dividends, structuring of rights offerings and solicitation of votes enable the execution of corporate actions. Moreover they allow issuers to attend to investor demands without revising the equity issuance and trading patterns of the home country.



If the shoe doesn't fit, must we change the foot?

Till recently, privatization was the trump card in the hands of the government of Pakistan to revitalize the splendor of nationalized banks and industrial units. Aimed at enhancing microeconomic efficiency and fostering economic growth, privatization is believed to strengthen old units through injection of new blood while establishing a platform for local and foreign investors to realize the real worth of the assets and hence capitalize on the given opportunity.

The positive impacts of the privatization policy were soon reflected when state owned enterprises that were fighting for their survival at one point in time were transformed into mines of gold for local and international business groups once they were privatized. Take the example of the major banks of the country namely MCB, HBL and UBL that took a positive swing post privatization.

This wave of restructuring and downsizing did not only change the future prospect of the concerned units but also provided an effective means to earn Foreign Direct Investment and finance the burgeoning current account deficit. However, this ritual of using the privatization proceeds for financing a significant part of the deficit has met with immense controversy lately.

After succeeding at privatizing a number of big entities, the government encountered significant hurdles as the privatization program failed to go as smoothly as expected. With the plan to privatize SSGC and SNGPL put on hold, and that of PSO being in limbo for quite some time, the controversy over the privatization program strengthened. And last but not the least is the case of the Pakistan Steel Mills Corporation (PSMC). Constituting thousands of employees running the biggest and the only Steel Mill of the country, this unit was intended to be privatized by mid of 2006 but unfortunately, the attempt to privatize PSMC turned out to be another nail in the coffin for the privatization program.

Now that this coffin awaits its burial, the GDR launch of MCB rings a new bell of hope for the economy to attract foreign investment and finance the rapidly increasing current account deficit at least partially. It is no surprise then, that the upcoming GDRs of OGDC, KAPCO, NBP, HBL and UBL are being warmly welcomed. However, it is important to examine if these issues are being welcomed due to the recent setbacks of the privatization program that seem to provoke a farewell to the program all together.

Stimulating issuance of more GDRs by other enterprises, MCB's GDR is not here to substitute for the failures of the privatization program. In fact, MCB has paved way towards a new direction for the government to revive the privatization program.



Tug of War: GDRs vs. Direct Privatization

GDR's inherently enjoy a greater advantage over direct privatization. Based on a market determined price, GDRs present a more transparent process than direct privatization. Direct privatization tends to be more vulnerable to political maneuverings as it is not just an economic and commercial process but fundamentally a political one as it alters the distribution of power within a society. For this reason increasing pressure is mounting on the government for enhanced transparency in its privatization policies. This stimulates the government to shift its focus towards GDRs that being more market oriented are less susceptible to such intrigues.

Next, GDRs can be sold off easily to several investors as opposed to the case of privatization where a buyer with a strategic interest and an appropriate bid has to be located.


Lastly, state owned enterprises that are not privatized to prevent national strategic interests can be privatized through issuance of GDRs. For instance, privatization of certain enterprises is believed to be delayed due to the fact they have a strategic significance beyond the mere financial factors usually considered in such deals. Under such scenarios, GDRs can be used as an instrument to privatize national units. This is due to the fact that through GDRs the government can sell shares in such organizations without relinquishing control.

These inherent advantages have provoked a popular feeling in the market as it is being widely believed that GDRs are here to do us the good that privatization failed to do. It is important to note, that though GDRs present a number of advantages over direct privatization, they can in no way substitute for the program all together. Fundamentally, GDRs fail to accomplish the most important and basic feature of direct privatization; that is transfer of control. The main objective of privatization is transferring management of productive operations and assets from the public sector to the private sector to enhance microeconomic efficiency. GDRs often fail to accomplish this objective.

Hence, it is important to note that privatization and GDR issues are complementary to each other in essence. Privatization results in restructuring of the company while GDR gives an exit point for the investors or give new investors a chance to share the success of the company. Moreover, GDRs enhance the prestige of the economy increasing its global exposure and hence helping the direct privatization process.

Alone we can do so little; together we can do so much!

Take the case of MCB. Since its inception in 1947, the bank has undergone considerable internal reorganization as it was nationalized in 1974 and re-privatized in 1991. Lately, the costs have been trimmed significantly while the staff has reduced by almost 40%



from 15,000 in 1996 to 9000 at present. In quarter ended September this year, the bank recorded a net profit of US\$ 96.46 million that was up almost 90% in six months. Hence it is undeniable that once MCB announced to issue its US\$ 150 million GDR, investors were instantaneously attracted due to the bank's merits that were enhanced post privatization. In addition to MCB's own merits, however, investors were also drawn to the fact that the lender offers a leveraged exposure to Pakistan's economic growth, which the government expects to remain in the 6-7% range in the coming five years.

With the US\$ 150 million GDR issue, MCB attracted a demand worth of \$700 million. Additionally, the pre marketing and road shows induced a considerable heavy purchase of the bank's Karachi listed shares that dribbled its effects on other banks in Pakistan as well. Consequently, since the issue the banks share price has increased by almost 23% since mid September (when the pre marketing initiated) to 30th October close at PKR 280.55. This must instill an ambiance of confidence among entrepreneurs and the government to issue GDRs as an effective means to raise funds. MCB has not only strengthened its prestige with the GDR issue but has in fact placed the ladder for the economy of Pakistan as a whole to climb the global stage.

Internally driven, the economy of Pakistan presents a thriving opportunity to foreign countries as it can be a remarkable hedge against negative surprises in the American and European markets. In spite of this, Pakistan fails to attract significant foreign investment. Now, with issuance of GDRs global exposure to the economy is enhanced, that would help in attracting foreign investment. For e.g. with MCB's listing on London Stock Exchange due to its US\$ 150 million GDR, British investors are taking notice of the issue and hence examining the information on the Pakistan's economy. This shall highlight the opportunities that exist in our economy for foreign investors, stimulating opportunities for foreign investment.

Going forward with the economy expected to grow at almost 7%, Pakistan is very well placed to make its mark on the international front. The MCB GDR and the upcoming GDRs of NBP, UBL etc. if successfully executed will only help Pakistan's image globally. Thus the priority for the government should be the successful completion of these issues so that the process initiated by MCB gains momentum. Subsequently, the government must continue to draw foreign institutional investors through issues of GDRs to keep Pakistan in the limelight.



Economic Snapshot

Fiscal year 06															
Units	Aug	Sep	Oct	Nov	Dec	Jan	Feb	March	April	May	June	July	Aug	Sep	
<u>Inflation</u>															
Headline Inflation	%	8.41	8.53	8.27	7.89	8.51	8.76	8.05	6.91	6.16	7.12	7.65	7.63	8.93	8.73
Core inflation	%	7.55	7.58	7.81	7.59	7.36	7.34	7.00	6.67	6.43	6.58	6.29	6.28	6.20	6.16
Food inflation	%	7.82	7.52	6.41	5.84	8.1	8.17	7.48	5.42	3.64	5.59	7.78	7.44	11.08	11.26
Non-food inflation	%	8.83	8.25	9.61	9.38	8.8	9.18	8.44	7.98	8.01	8.21	7.55	7.77	7.43	6.98
<u>T-bill (Wgt Avg)</u>															
3 month	%	7.99	8.10	8.10	bid rej	8.09	8.10	8.10	8.10	8.10	8.10	8.29	8.32	8.63	8.64
6 month	%	8.12	8.14	8.14	bid rej	8.25	8.29	8.29	8.29	8.29	8.29	8.45	8.49	8.81	8.81
12 month	%	8.78	8.79	8.77	8.79	8.77	8.75	8.78	8.79	8.79	8.79	8.79	8.79	9.00	9.00
<u>External Sector</u>															
Export	Mln US\$	1,360	1,318	1,317	1,205	1,451	1,252	1,287	1,536	1,432	1,498	1,512	1350	1383	1420
Import	Mln US\$	2,056	2,037	2,021	2,024	1,929	2,037	1,854	2,269	1,664	2,299	2,626	2370	2292	2450
Trade balance	Mln US\$	(696)	(719)	(704)	(819)	(478)	(785)	(567)	(733)	(232)	(801)	(1114)	(1020)	(909)	(1030)
Remittances	Mln US\$	348	341	373	309	336	391	339	444	401	507	464	376	435	422
Forex reserves	Mln US\$	12,124	12,000	11,715	11,341	11,669	11,505	11,516	12,487	13,021	13,003	13,137	12,725	12,631	n.a
n.a = Not Available															



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