Market Bubbles, Structural Developments and Present Trends: An Overview of Bangladesh Capital Markets

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Bangladesh Capital Markets: An Overview

Over the last 12 years, the Bangladesh economy has sustained average GDP growth of around 6% per year, accompanied by significant shifts in the sectoral output, away from agriculture to industry and services, towards an increasing contribution of the private sector to growth in investment. One of the drivers of the private sector contribution to investment has been the remarkable growth of the Bangladesh banking sector. Although less than a quarter of the population are formally classified as "banked", there are over 50 private commercial banks in the country, and several of them have acquired mobile banking licenses to bridge the gap between the banked and the unbanked.

With regard to capital markets organizations, although merchant banks and brokerage firms typically constitute the non-banking financial institution (NBFI) sector of the economy, several banks have sister-concern brokerage firms and merchant banks. However, despite the growth and development of the banking sector, the NBFI sector at large, and the capital markets in particular, have lagged behind.

Although stock exchanges were formally inaugurated in Bangladesh as early as 1954, the markets did not see any noticeable activity until 1990s. Until the 1990s, with regard to both the existing exchanges, the Dhaka Stock Exchange (DSE) and the Chittagong Stock Exchange (CSE), standard indicators of market performance – number of equities traded, average turnover and market capitalization to GDP ratios – remained significantly lower than indicators for regional counterparts. The regulatory environment was inadequate and market regulations outdated and not systematically enforced. In this milieu of weak institutional structure and inadequate governance, the market experienced its first speculative bubble and burst in 1996-1997. Investors who were affected due to the bubble and burst stayed away from the market for the next several years.

However, the bubble and burst also led to operational developments such as the introduction of electronic trading in August 1998, the establishment and incorporation of the Central Depository Bangladesh Ltd (CDBL) as a public limited company in August 2000, and the incorporation of the Central Depository System (CDS) as an independent company in January 2004.

From 2007 onwards, in the aftermath of the largest IPO at the time, that of Grameenphone Ltd., the market began to appreciate culminating in a significant bubble in 2010. In 2010 alone, the DSE was the second-highest performing market globally, with the general index, DGEN, posting a 92% y-o-y return. However the bubble was short-lived, as the market began to slow from December 8, 2010, beginning a protracted phase of contraction.[1]

Stock Market Crash 1996

In 1996, the number of Beneficiary Owner (BO) account holders was only 25,000 and most of them were new to the market. The number is put into context when one considers that the number of BO accounts opened in February 2010 alone was 250,000.[2] The Dhaka Stock Exchange was yet to witness electronic automated trading, as paper shares used to be sold in front of the DSE, which rendered the detection of fake shares from original ones, considerably difficult. Between 1991 and 1995, DGEN price index rose 139.3% to reach 834.

Subsequently, in 1996 alone, the rate of appreciation took a dramatic turn, and the price index rose 337%, with DGEN reaching 3649 on November 5, 1996. Meanwhile, the CSE also experienced a dramatic uptrend, appreciating 258%. The CSE Index appreciated from 409 to 1157 points in 1996. November marked the turning-point, with the DGEN losing 233 points on November 6, 1996, which initiated the downturn. In less than six months, as the bubble burst, DGEN index dropped to 957 in April 1997, erasing gains of the previous ten months. The market slowdown continued for the next 7 years until April 2004, during which time, DGEN seldom crossed 1000.[3]

In 1996, the sharp increase in the general index was the obvious indicator of bubble formation. In fact, in developing countries like Bangladesh, the formation of bubbles is usually more easily discernible, and can be judged from anomalies in index trends alone. Weak correlation between underlying fundamentals of companies and the prices of their stocks are usually sufficient to determine bubbles. However, given the embryonic stage of capital markets in Bangladesh in 1996 as well as very low levels of investor literacy, investors resorted to heavy usage of margin lending, fueled by accelerated money and credit growth.

Moreover, there was significant collusion between certain brokerage houses and listed companies, which ensured the uptrend of certain companies' stock prices between June and November 1996. Certain companies that were listed from 1994 onward, through relatively small IPOs, played an important role in the crash. For instance, Excelsior Shoes, which issued 11,850 shares with a face value of BDT 100, managed to sell 10,000 shares at BDT 503 each, on its first day of trading, on account of relations with particular brokers.

Shinepukur Holdings experienced a similar uptrend as its share price rose from BDT 70 to BDT 700, while companies such as Wonderland Toys, Jihil Bangla, Rupon Oil, and Mark BD, also experienced and contributed to the price bubble, reportedly, in collusion with brokerage houses.[4]

One of the noteworthy take-away's from the crash of 1996 is that the bubble had formed within a very short period of time. The DGEN at its peak on November 5, 1996, had appreciated by 332% in only six months. When the market began to reverse, the correction also occurred very quickly. This is not unusual of stock markets at very early-stages of their development, since the index's rise and decline are usually a function of collusive behavior between institutional investors, high-net worth investors and brokerage firms, which cumulatively, drive the majority of the volume of shares traded. Retail investors tend to suffer in the wake.[5] The quick uptrend and downtrend was also a function of the rather small market capitalization of the DSE and CSE at the time.

Stock Market Crash 2010

After a protracted period of relative inactivity, the DGEN began to recover in April 2004. Although DGEN recorded a CAGR of 14.63% from 2001 to 2009, it was not until late 2007, that the index showed any sustained appreciation. In late 2007, several foreign institutional investors (FIIs) began to take positions in leading Bangladeshi equities – both multinational company as well as large local conglomerate stocks – partially driven by a global move towards frontier market equities, and partially in response to favorable corporate fundamentals. The 12-month cumulative net inflow of foreign funds reached US $148 million in October 2007. As is the case for most frontier markets, infusion of foreign funds into equities tend to stabilize the market and pave the way for appreciation, since foreign investors tend to not be day-traders and prefer long positions instead, on the basis of company fundamentals.

Next, in 2009, DGEN posted a 62% appreciation y-o-y. However, the most significant acceleration of the index set in from November 2009 around the time of IPO of Grameenphone. On November 15, 2009, a day before the launch of trade of GP shares, DGEN stood at 3383, 28% higher from January 2009. In only one day – on November 16, 2009 – the DGEN rose to a historical high of 4148, which marked a 23% rise day-on-day. The sharp appreciation was partially attributed to the incorrect calculation of the index after the largest IPO in history at the time – that of Grameenphone.[6]

Thereafter, DGEN continued to climb sharply, reaching 5828 on February 17, 2010, registering a 71% increase from November 2009. Between February and May, the index took a minor dip to 5500, but from the second week of May, the bubble was back in force, reaching 6333 on June 13, 2010.[7] Fuelled by investments by banks, the DGEN reached 8500 by the second week of December. At the time, the market capitalization of the DSE was around US$ 52 billion, about 50% of the nation's GDP at the time, and more than 60 times the market capitalization of the year 2000.[8]

A leading indicator for the bubble in the market was the number of BO accounts. The number of registered BO accounts with the CDBL increased from 17.94 lacs in end-December 2009 to 19.07 lacs in January 2010. As of June 2010, the number of BO accounts stood at 25.88 lakhs, thereby indicating that around 1.26 lac new retail investors took to the market every month in FY 2010.[9]

Another indicator of the bubble in the stock market was the price of DSE brokerage licenses. To cite specific examples, in 1998, NCC bought a DSE brokerage license for approximately BDT 400,000. In 2005, the price had reached BDT 80,00,000. In 2009, Dhaka Bank bought it for around BDT 15 crore or BDT 150,00,000. Sources also confirm license sales of between BDT 60-80 crores in 2010.[10]

In terms of the oft-discussed P/E ratio, i.e., the ratio of price to earnings, which is a quick way of determining whether a stock is overvalued in regards to its earnings, the weighted average P/E of the DSE increased, with the appreciation of DGEN. The DSE P/E ratio increased from 15 at end-2006 to 26 by end-2009, reaching 31 in February 2010. As P/E ratios increased, dividend yields declined from 3.6% in end-2006 to 1.7% in June 2010.[11]

As indicated earlier, the liquidity into the capital markets was driven by increasing routing of bank funds into the markets.[12] Banks with sister concern merchant banks and brokerage wings invested in the market either through margin loans through their merchant bank and brokerage concerns, direct portfolio investment, or indirectly, as several debt products from banks, including credit card loans, were routed by bank customers into the market.[13]

Meanwhile, with regard to FIIs, as the market continued to heat up, they began to pull out of their positions and the twelve-month cumulative net withdrawal from DSE peaked to US$486 million by April 2010. By the time the index peaked in December 2010, it is believed that virtually all foreign portfolio investment had been withdrawn from the market. In fact, between 2009 and 2010, sizable amounts were withdrawn from the stock market and FIIs booked capital gains and awaited the market correction.

Once the most significant phase of the market correction ended in around April 2011, FIIs began to return to the market from May onwards to pick up undervalued stocks. Statistics indicate foreign investments in Bangladesh's bourses peaked in 2013 at $930 million that dropped to $610 million in 2014.This is a significant sign of market recovery, and bodes well for the market heading in 2016 and 2017, since foreign portfolio investment tends to have lagged effect on the market.

Table 4.1 shows some selected indicators of capital market developments referring to three choice years: year 2007 representing the pre-bubble era, year 2010 representing the peak bubble year and finally 2015 showing the recent scenario.

Indicators of Market Development (DSE)

Indicators	**FY 2007**	**FY 2010**	**FY 2015 (as of 1H 2015)**
Number of listed securities	281	279	330
Issued equity and debt (billion BDT)	83.7	213.1	1,092.0
Market capitalization (billion BDT)	412.2	2277.0	3,251.0
Turnover (billion BDT)	164.7	2714.3	476.7
General Price Index	2149.3	6153.7	4586.9
DSE Broad Index	n/a	n/a	4,583.1
DSE-30 Index	n/a	n/a	1,769.4

Source: DSE and ULAB Research

Stock Markets: Present & Future

On January 28, 2013, the DSE launched three new indices: the DSE Broad Index ("DSEX"), DSE 30 Index ("DS30") and the DSE Shariah Index ("DSES"). The first two, DSEX and DS30 were designed and developed by S&P Dow Jones, the leading global provider of benchmark indices. On 29 April 2013, The Exchange Demutualization Act 2013 was passed by the National Parliament of Bangladesh, gazetted on May 2, 2013. An Appellate Board comprising retired judges from the High Court Division was also formed to settle investor claims related to the 2010 market collapse. Surveillance software has been installed in order to maintain transparency and accountability of the markets through closer scrutiny of transactions.

Both the Securities and Exchanges Commission Act 1990 and Securities and Exchange Ordinance 1969 have been amended. Despite some initial delays, both the Demutualization Act[14] and the Banking Control Act (BCA)[15] have been submitted to and approved by the Parliament, and the demutualization of Dhaka and Chittagong Stock Exchanges have been completed. Also after initial delays, the new Financial Reporting Act which includes provisions for setting up an independent Financial Reporting Council has been approved by the Parliament in September 2015.[16]

With regard to the outgoing year 2015, the market overall, yielded a negative 4.8% return, which is hardly a disaster keeping in mind that for business activity in the country was significantly slowed down in the early part of the year, due to political turmoil and blockades. The year also witnessed certain decisive steps by the government. First of all, corporate income tax for listed companies was lowered and rules for new stock and mutual fund issues were revised, which are expected to have a delayed impact on the market. A second silver lining of 2015 was the fall of short- and long-term interest rates in the economy. The depositors' rate is below double-digit after being above double-digit in 2013 and 2014. The money market has idle funds as evidenced by some of the lowest call money rates in recent history and the savings rate on national savings instruments have also declined.

A determinant of the performance of fledgling stock markets also tends to be the issuance of stocks of large multinational companies or large local conglomerates. In the case of the former, the last multinational company to be listed with the bourse was Grameenphone in 2009. Ever since that IPO and the resultant the bull run of the stock market and eventual collapse, multinationals have been hesitant to avail of stock market listings. Currently, 13 multinational companies are listed on the DSE, including Bata Shoe, Grameenphone, Heidelberg Cement, Lafarge Surma Cement, British American Tobacco, Berger Paints, Linde BD and Singer Bangladesh. These companies usually constitute the blue chips of a Bangladesh-based equity analysts' coverage universe.

However, given that several new regulatory frameworks are in place, merchant bankers and analysts have redoubled efforts to persuade multinationals to come to the market. At the Bangladesh Capital Market Expo 2015, Commerce Minster Mr. Tofail Ahmed, urged the BSEC to prepare a comprehensive plan of action to list multinational companies in Bangladesh. Very encouragingly for the market, the Minster said, "Multinational companies like Unilever and Nestle should come to the market, and the regulator should make a comprehensive plan of action to bring in more such firms."[17] Steps towards actualizing this would enable long-term growth for the market.

Another positive development for the market was Bangladesh Bank circular that aims to redefine bank investment in the capital market, effective from January 2016. In essence, the circular stipulates that the capital provided by banks to their subsidiary companies will not come into the calculation of the parent banks' total capital market investment. Theoretically, this should translate to new investments in the capital market by banks, given that there is already excess liquidity[18] in the money market and in a relatively low-interest-rate economy. Moreover, since 33 of the 51 full-fledged merchant banks are bank-owned, the cumulative impact of this circular appears to bode well for the market.

[1] Interview with DSE Research Cell; ULAB Research
[2] Ibid
[3] Please see Financial Express BD article available at: http://old.thefinancialexpress-bd.com/old/index.php?ref=MjBfMTBfMTZfMTJfMV85Ml8xNDcwMzM=
[4] Interviews with brokerage houses and investment analysts; ULAB Research; See also Wahab, Md. Abdul, and Faruq, Md. Omor, "A Comprehensive Study on Capital Market Developments in Bangladesh," March 2012, Research Department, Bangladesh Bank, Head Office, Dhaka, Bangladesh
[5] Ibid.
[6] Ibid.
[7] Wahab, Md. Abdul, and Faruq, Md. Omor, "A Comprehensive Study on Capital Market Developments in Bangladesh," March 2012, Research Department, Bangladesh Bank, Head Office, Dhaka, Bangladesh
[8] DSEX Data, ULAB Research
[9] Wahab, Md. Abdul, and Faruq, Md. Omor, "A Comprehensive Study on Capital Market Developments in Bangladesh," March 2012, Research Department, Bangladesh Bank, Head Office, Dhaka, Bangladesh
[10] Interviews with brokerage houses and investment analysts at Lanka Bangla Securities and IDLC Securities
[11] DSE website
[12] Conceptually, the effect of banks' greater investment in capital market on private credit is not unambiguous. Banks have incentives to divert their portfolio to the capital market if the rate of expected return from the capital market is higher than the return from investing in the private real sector. This may make a bank reluctant and "lazy" in disbursing credit to the private sector, even if there is huge idle liquidity. The cost of idle liquidity can be well compensated by the income from the capital market. Higher expected return from the capital market may induce banks to reject socially desirable large projects with higher risk (e.g., physical infrastructure, etc.).
[13] Iqbal, Kazi, and Islam, Mir Ariful. Commercial Banks' Investment in Capital Market and Its Impact on Private Sector Credit. Bangladesh Development Studies. Vol. XXXVII, September 2014, No. 3
[14] The goal of the demutualizing a stock exchange is to reduce control of brokerage firms on the exchange by circumscribing brokerage ownership to a pre-determined amount and allowing private investors including retail investors to hold ownership of the stock exchange.
[15] The central bank earlier asked the banks to bring down their overall capital market investment within 25 percent of their respective total capital by 21 July 2016 in line with the Banking Companies (Amended) Act 2013
[16] The Act aims at elevating the auditing and accounting system of the country's financial institutions to international standards, and under the Act, Financial Reporting Council comprising 12 members will be established, led by a Chairman appointed by the government. See more at: http://old.thefinancialexpress-bd.com/2015/09/29/109602#sthash.qrPEqdKB.dpuf
[17]See more at Daily Star article available at: http://www.thedailystar.net/business/tofail-urges-foreign-firms-join-stockmarket-166045
[18] In the monetary policy statement (MPS) for 2H FY 2015-16, Bangladesh Bank (BB) cut its key interest rate by 50 basis points (bps) to 6.75% and repo rate by 50 bps to 5.25%. BB changed its policy rate after three years, since February 2013. Meanwhile, the inter-bank call money rate saw drastic fall of 3.69% in December from 5.79% in June last year, according to the BB data. See more at http://www.dhakatribune.com/business/2016/jan/15/bb-cuts-key-rate-credit-growth#sthash.u5cfRujH.dpuf

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