

COLOMBO STOCK EXCHANGE - BEYOND 1992

M. H. E. Shariff

Shariff is the Development Manager at the Bartleet Mallory Stockbrokers (Pvt) Ltd and the Sharemarket Reviewist for the Sunday Times (for the past two years). His other contributions include - How to make money on the Stock Exchange, Strike It Rich in the Stock Market (Investment Guide) - published in the Sunday Times in 1989 & 1990. He has also lectured for CIMA and NIBM on the Stock Market. Formerly stockbroker at the Trading Floor of the Colombo Securities Exchange (Gte) Ltd, he is also experienced in trading in Commodity Futures and received further exposure with visits to Commodity Exchanges in Japan and Hongkong.

The Colombo Stock Exchange can look back on a year in which positive elements held the upper hand. Price trends on the Stock Exchange were highly satisfactory. The Colombo Stock Exchanges' All Share Price Index registered a gain of 204.90 points. This was the largest annual gain ever made. Despite the Stock Market boom and government measures inducing companies to go public, the number of listed companies and issuing activity has still not gathered momentum. Thus pointing to the fact that the private sector is still noticeably hesitant to engage in equity financing. See Tabel I.

Both Capital increases by way of rights issues and new listings have still not shown a significant growth, see table II.

In relation to the upward momentum in price trends and higher market capitalisation the growth of both Rights Issues and as well as New Issues remains low. If the market is to show sustained growth with price spreads more evenly distributed relative to value of individual stocks then there must be a growth in New Issues to justify higher market capitalisations. Nevertheless, a perceptible improvement in the situation has been visible in the last few months. New Is-

The opinions expressed are the writers own and does not reflect the views of the organisation he works for.

suces have started to pick up. In the past one month or so two new issues, namely Ceylon Oxygen Ltd. and International Tourists & Hotelliers Ltd. (Beach Hotel Bayroo) were oversubscribed in less than a week from the date of offer. It is worthwhile to note that the share market which remained dormant in the 1970's following the then government's 'nationalisation policy' which took effect with the Land Reform Law of 1975 and the subsequent state acquisition of quoted companies owning a large number of tea, rubber and coconut estates, began to show signs of optimism as early as 1983. In this year alone there were twenty five new issues and a total quantity of 170 million shares

valued at Rs. 1.7 billion were issued for public subscription. The largest offer so far attempted on the Colombo Stock Exchange was Rs. 383 million, by the Pelwatte Sugar Co Ltd. One likely reason for the rise in shareownership since 1980 is the high level of confidence, due to the strength of the economy and personal finances of individuals. But one should not forget that investments in shares must compete with savings. However there is a growing acceptance of shares as a key part of many savings portfolios. It is for this reason that the Stock Exchange considers that the conduct of a fair and orderly market requires every listed company to make available to the public, information necessary for informed investing; and to take reasonable steps to ensure that all who invest in its shares enjoy equal access to such information. In this regard the exchange has specific policies concerning disclosure embodied in the Colombo Stock Exchanges' Rules & Regulations under the heading corporate disclosure policies in section 8. While Sections I & III of the same document enumerates aspects concerning Criteria for Admission and Continuing Listing Requirements.

It may be pertinent to state here that companies want to be quoted on the stock exchange for several reasons. In the Report on the Survey of Public Quoted Companies of Sri Lanka 1984 by D. L. L. P. Jayawardane of the Department of Registrar of Companies the

Period of Quotation	Number Quoted	Percentage
Upto 1948	27	14.83
1949 to 1977	57	31.31
1978 to 1988	95	52.19
1989 to 1990	3	1.64
Total	182	100.00

Source: Dept. of Registrar of Companies, CSE Annual Report, CSE Fact Book several issues.

Rights Issues, New Issues during the period 1988 to 1990				
Year	Rights Issues	No. of Companies	New Listings	No. of Companies
1988	320,373,610	12	79,462,500	8
1989	90,696,350	7	140,000,000	2
1990	494,903,516	12	7,000,000	1

Source: CSE Annual Reports 1988 and 1989, CSE Fact Books several issues.

following are cited as some of the reasons for obtaining a Quotation. According to the findings of the survey, "The need to raise part of the capital" has been given by over a third (38.9%) as the principal reason that influenced them to seek a quotation. The second highest proportion of companies which obtained a quotation was influenced by the ideas of 'obtaining a ready market value for their shares'. The proportion of companies adducing this reason was in the region of 20.4%. While 16.8% of the companies sought a quotation with a view to broadbase the share structure in order to bring share ownership within the reach of the common man. Financial and tax incentives available to quoted-companies has attracted 16.1% of those listed, see table III.

I would like to further enlighten the reader with particular emphasis on reasons for obtaining a quotation.

1. The need to raise capital

Sri Lanka has a long history in company formation, share and share trading. The first Companies Ordinance in the then Ceylon was passed shortly after similar legislation in England in 1875. This period saw the establishment of the large number of coffee plantations by the British Community with Capital brought from the mother country, and private ownership being the predominant form of ownership. After a few decades tea replaced coffee as the principal crop when misfortune reached its culmination, with the destruction of coffee plantations due to a leaf fungus. The large increase in the plantations necessitated the formation of limited liability companies and com-

panies were formed both in Colombo and London for the purpose of harnessing capital to develop the tea industry. The lack of capital to expand their commercial activities led to the birth of the Colombo Share Brokers Association in 1886, and the companies that were floated were able to obtain the necessary finance by way of share issues through this market. The British who pioneered coffee, tea and associated business as stores suppliers were not always persons with much capital of their own. Therefore they had to obtain money from others. If they went to a bank they needed sureties and guarantees. They would mortgage their assets but a bank could not finance a yet non-existent plantation. Therefore they formed companies to hold the property of the venture and offered shares to the public. The Colombo Share Brokers Association allowed such companies to advertise the prospectus of their venture and sell their shares to a wide range of investors. This mechanism enabled funds to flow from those who did not require it to those who needed it for business. In this way capital to launch business was raised. The other commercial crop that was introduced to the economy by the British was rubber in the 1880's. Coconut was also organised as a part of commercial domestic crops. Through exports, the country was able to earn sufficient foreign exchange to finance all essential imports, including rice in which the country had been self sufficient before 1880. During the pre-independent era the economy was a dualistic export economy divided into two sectors; one was modern in organisational structure and technology, producing for the world market, and the other was traditional in both regards,

producing for the domestic market. The dynamics were extremely simple in this economy, and rapid growth was limited to the plantation sector, resulting in lopsided development of the economy. The predominance of the export sector, rendered the economy as a whole vulnerable to fluctuations in the prices of the country's three main exports; tea, rubber and coconut in the world market. Although commercial banks were established mainly to supply the requirements of the plantation sector before 1948, the independent government spread banking facilities into the sectors of the economy. The two major domestic commercial banks, the Bank of Ceylon and the People's Bank which are controlled by the government, owned 90% of the bank branches in the country in 1980. In the year 1904 the name of the Colombo Share Brokers Association was changed to Colombo Brokers Association. (CBA), and trading on a call over system with representatives of Brokers Association. (CBA), and trading on a call over system with representatives of Brokers firms continued upto 1984 June under the bi-laws of the CBA. The heyday of the Sri Lanka tea, rubber and coconut plantations lasted for a century between 1850 and 1950 and left behind a legacy of 266 quoted companies in the Colombo Share Market.

With the eclipse from a plantation economy to an industrial economy, and the new economic policies of 1977 and the re-emergence of the Private Sector as a dominant force in the economy resulted in the re-structuring of the Stock Market with a Trading Floor open to the investing public from 2nd July 1984.

Other than export processing units, there were few factories before the inde-

TABLE III REASONS FOR OBTAINING A QUOTATION FROM THE STOCK EXCHANGE BY NO.OF COMPANIES

Reasons	Agriculture		Manufacturing and other Industries		Export Import & Trading		Banking		Finance		Investment		Property Dev. and Construction		Hotel Services and Tourist Industry		Other		Total	%
	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%	No.	%		
1. To Raise part of Capital	--	--	25	41.0	4	19.0	1	50.0	2	25.0	1	33.3	5	35.7	22	61.1	5	35.8	65	38.9
2. To Benefit from Tax Incentives	2	25.0	10	16.4	4	19.0	--	--	1	12.5	--	--	1	7.1	8	22.2	1	7.1	27	16.1
3. To Obtain a Ready Market value for Shares	5	62.5	9	14.5	7	33.4	1	50.0	1	12.5	--	--	2	14.3	4	11.1	5	35.7	34	20.4
4. To Gain Access to Capital Markets--	--	--	1	1.6	--	--	--	--	--	--	--	--	1	7.1	--	--	2	14.3	4	2.4
5. To Broad Base Ownership	1	12.5	15	24.5	3	14.3	--	--	3	37.5	--	--	3	21.5	2	5.6	1	7.1	28	16.8
6. To Facilitate the Purchase and Sale of Shares	--	--	1	1.6	3	14.3	--	--	1	12.5	2	66.7	2	14.3	--	--	--	--	6	3.6
7. Other	--	--	--	--	--	--	--	--	--	--	--	--	--	--	--	--	--	--	3	1.8
Total	8	100.0	61	100.0	21	100.0	2	100.0	8	100.0	14	100.0	36	100.0	36	100.0	14	100.0	167	100.0

Source : Dept of Registrar of Companies.

pendence of the country; a cotton mill, a tile factory, two distillers, two match factories, and few engineering workshops dealing with estates. During World War II the colonial government and the private sector started several factories to produce basic consumer goods, which could not be imported due to the war. However the free flow of imports after the war discouraged most of these manufacturing units.

A large number of the prevailing industries were established during the last three decades or so. These industries include cement, tyre, ceramic, steel, paper, chemicals, petroleum, fertilizer, hardware, garments, large scale textiles and some food factories, sugar, flour milling and dairy products. All economic plans prepared for the country have recognised the necessity of industrial development. Continuous expansion in this sector will be required in future to absorb the increasing labour force and to diversify and increase export earnings, because the development of agriculture has its own limitations. Expansion into foreign markets is necessary for greater industrialisation, because it will help to overcome both the foreign exchange problems and the limitations due to the small domestic market. Most of the manufacturing industries in the country were started after independence in 1948 and are the result of the government import substitution programmes.

The new industrial strategy was introduced by the Ministry of Industries with a view to restructuring the overall domestic industrial policy. This was approved by the Cabinet on December 27, 1989. The new industrial strategy intends to (a) transform the import substituting industry to an export oriented industry, (b) provide greater employment and income opportunities, (c) diversify the economy and strengthen the balance of payments and (d) ensure a more equitable distribution of income and wealth. The strategy also includes policy measures aimed at mobilising resources for investment and exports; encouraging foreign and local investments; reforming public enterprises; promoting a competitive environment; establishing linkages between large and small industries; promoting research,

training and marketing and removing administrative obstacles to investment, production and exports.

In recent months there has been an encouraging revival of capital raising on the Colombo Stock Exchange, to the benefit of both saver and entrepreneur. In the past five years or so the Stock Exchange has raised money with great success. In addition to new issues, these years have also seen many companies enjoying a spectacular expansion of their capital base by way of rights issues. A rights issue is a new issue of shares made to existing shareholders in proportion to their shareholdings for the purpose of raising further capital for the company. Rights issues are therefore offered at a price which is less than the market price of existing shares, otherwise there would be no incentive for shareholders to accept the offer. Since there is no obligation on the shareholder to accept the offer so he may allow it to lapse. Furthermore a rights issue is renounceable which means the shareholder can sell or transfer his rights if he does wish to take them up. The rights can be traded on the exchange for a specific period. Although the cost of funds raised by a rights issue is controversial, there are a significant number of companies which utilise this mechanism. In this manner such companies are able to keep leverage at its minimal whilst benefiting from the advantage of not having to borrow at high levels of interest.

Whilst rights issues are made by quoted companies wanting to expand its capital, new capital issues are made either by new companies promoted by well-known local or foreign interests (or both, in the case of joint ventures), or by private companies which have been long established and wish to "go public" by floating (selling) a portion of their share on the market. There are four main ways in which the share of a company can be quoted for the first time on the Stock Exchange:

- (a) an issue by prospectus
- (b) an offer for sale
- (c) a placing
- (d) an introduction.

Advice on new capital issues – the form of capital, the amount that can be raised, the different methods of issue, timing, preparation of the prospectus, application for quotation, issue expenses, underwriting etc. can be obtained from members of the Colombo Stock Exchange, development banks and merchant banks. Most public issues are of ordinary shares. Companies applying for quotation of ordinary shares are, as a general rule, expected to meet the following requirements:

- (i) Have a paid up capital of at least Rs. 5,000,000/-
- (ii) The following percentage of the issued capital should be in the hands of the public depending on the category to which the company belongs:

Below Rs. 10,000,000	-40%
Rs. 10,000,000/- to	
Rs. 25,000,000/	-30%
Above Rs. 25,000,000	-25%

When complying with this requirement the following are to be excluded:

- (a) Holding by parent, subsidiary or associate companies.
- (b) Holdings by Directors, members of their families and/or their nominees.

2. Obtaining a ready market value for shares

The price of shares of a company on the secondary market is determined by the simple forces of demand and supply – what buyers will pay and sellers accept. The rewards of investment are not always in the form of dividends. If the price of a share rises between the time of purchase and the time of sale, the investor makes a capital gain or profit. This would enable major shareholders to sell a portion of their holdings in order to invest elsewhere.

3. Financial and Tax incentives available to quoted companies.

At present all Public Quoted Companies are subject to income tax on profits at a concessionary rate of 40% (as opposed to 50% applicable to other companies), provided it complies with the following requirements:

(I) The number of persons registered as shareholders of the company should exceed 200.

(II) No five persons together should hold directly or through nominees more than 60% of the total issued share capital of the company.

Additionally shareholders in listed companies have the following tax benefits:

(I) Capital Gains arising from the sale of shares in a Public Quoted Company will not be liable for taxation if the sale occurs after a holding period of one year.

(II) Dividends distributed on or after 1st April 1991 by a public quoted company to its shareholders would not be subject to any withholding tax thereon.

(III) The 15% withholding tax would however continue on dividends payable to non-resident shareholders.

4. To broadbase share ownership

Almost every entrepreneur has a dream that he will be able to build up his own business as a private company, and then, because of its success and opportunity for further growth, be able to sell it to the market. For many the happiest solution is to find large numbers of individuals prepared to buy a total stake, of say 40%, so that the original founder and his family may retain control, while utilising the cash generated by the sale for a different venture. This is possible because the Stock Exchange acts as a financial intermediary in raising money for business and enterprise. It has developed from two complementary economic needs – an organisation's need for funds and an individual's need to invest his surplus money efficiently. The result is that surplus money is invested in organisations which need it. Therefore a strong advantage to an expanding business in being listed on the Colombo Stock Exchange is that the company attracts unsolicited funds. If investors think that the company is doing well, any number of investors will buy its shares.

The need for a second board?

Dr. Darin C. Gunasekera in his article titled "The Provision of Capital to Stock

Exchange Listed Companies" wrote that "167 listed companies accounted for only 47,341 jobs. This incidentally amounts to an issued capital of various vintage rupee of Rs. 128,000/- per job. This is a high per job cost both in terms of the national economy and by general domestic company standards. It suggests that the quoted companies are high capital intensity end of the Sri Lankan commercial sector. This actually confirms economic logic. The Stock Market was being promoted by tax measures that made cost of capital low and provided Government enhancements to increase returns to capital. So we diverted national resources into this market where capital intensity – generally speaking imported machines and modern buildings was much higher."

I am of the view that the market has evolved to be what it is purely due to acceptability or demand for shares thus ensuring marketability. Yet it is important that risk capital is made available to medium and small scale industries via the Stock Exchange. Particularly because this sector contributes significantly towards the country's output, and therefore has the greatest potential for growth in the long term. Since such companies will not meet the listing criteria set out for larger ones, but still requires funds to finance a project or product where income can soon be expected to flow. It may be a timely measure to establish a second board with no restriction on size for candidate companies and for ongoing operation but must have at least one years financial records in support of its entry to the second board.

GLOSSARY

All Share Price Index – Statistical tool that measures the state of the Stock Market, based on the performance of shares.

Broker – An agent who makes purchases and sales between other parties for a commission (brokerage).

Broadbase – To spread share ownership among more individuals.

Public Company – Any seven or more persons associated for any lawful purpose by subscribing their names to the memorandum of association and complying with the requirements of the Companies Act after registration.

Private Company – In the case of a private company two or more persons are sufficient to incorporate the company.

Listed/Quoted Company – These are public companies whose shares are available for trading at the Colombo Stock Exchange.

Issued Shares/Capital – Issued is that part of the authorised capital that the company has already issued to the public for subscription.

Dividend – The distribution of usually part of the profits at the discretion of a company's board of directors.

Diversification – Spreading investment among different shares of different companies in different fields. Diversification is also offered by the shares of several individual companies because of the wide range of their activities.

Leverage – The effect of fixed charges (ie. debt interest or preferred dividends, or both) on per share earnings of ordinary shares. Increases or decreases in income before fixed charges result in magnified percentage increases or decreases in earnings per ordinary share.

Market Price – The list price at which a share sold at the trading floor of the Colombo Stock Exchange.

Par Value – The stated face value of a share, expressed in rupees per share. Par value of an ordinary share usually has little relationship to the current market price.

New Issue – An offering of shares sold by a company for the first time.

Offer – The lowest price which a person is ready to sell; as opposed to bid, the highest price at which one is ready to buy.

Rights Issue – A temporary privilege granted to existing ordinary share holders to buy additional shares of a company.

Prospectus – A legal document which describes shares being offered for sale to the public and various particulars concerning the project or enterprise.

Stock Exchange/Sharemarket – Is the market place for issued shares which are tradeable. New issues are offered to the public via the Stock Exchanges' primary market.

Shareholder – A person whose name is registered in the records of a company whose shares he holds.

Contd on page 59

Capital Gain or Loss – Profit or loss resulting from the sale of a capital asset.

References:

Report on the Survey of Public Quoted Companies of Sri Lanka 1984 – Department of Registrar of Companies Colombo – 2. Management Accountancy in Sri Lanka by A. H. M. Bennett (Volume I), 1987.

Rules & Regulations – Colombo Securities Exchange. Colombo 1.

A Macroeconometric Model for Sri Lanka by A. G. Karunasena, Central Bank of Sri Lanka. Colombo Securities Exchange (Gte) Ltd – Annual Reports 1988 & 1989.

CSE Fact Books – June & December 1990.

Subsidiary – Company which is controlled by another company usually through its ownership of the majority of shares.

Underwriting – The purchase for resale of a share by an investment company bank

Flotation – Issue of shares.

Asian Stock Markets, The inside story by Anthony Rowley – 1987.

Central Bank of Sri Lanka, Annual Report 1989.

The 3rd Market – The International Stock Exchange of UK, 1987.

How the Stock Markets Work by Collin Chapman, 3rd Edition 1988.

New York Stock Exchange – Glossary, 1987.

Public Investment 1988 – 1992 – National Planning Division, Ministry of Finance and Planning, Colombo, Sri Lanka, 1988.

The Provision of Capital to Stock Exchange Listed Companies by Darin C. Gunasekera, Economic Review March 1989.