There's Security in Securities

Though still small, the Lithuanian stock exchange is set to become increasingly attractive to investors

By Andrius Bogdanovičius, Policy Analyst, LFMI
published in *Lithuania in the World* , 2001 No. 5

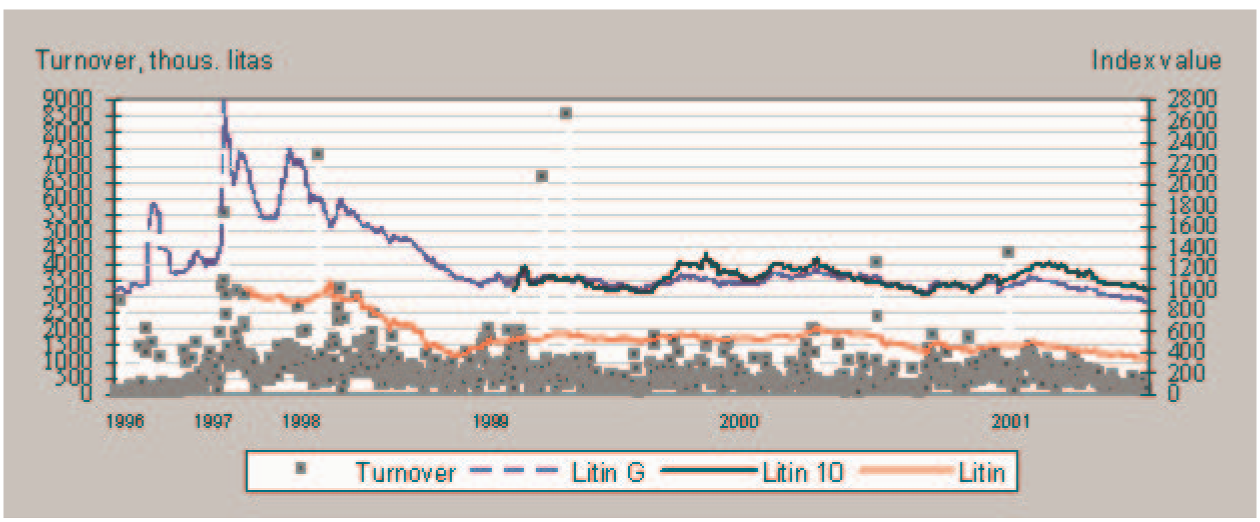
Those who are interested in investing in the Lithuanian securities market find Lithuanian companies attractive by various indicators. As an example one may take the ratio of share price to net profits. In the first quarter of 2001 this indicator for the securities quoted on the National Stock Exchange of Lithuania was nine, or several times lower as compared with other stock exchanges. On the other hand, there are many other factors that potential investors should take into account while making investment decisions.

The market in brief

The shares of Lithuanian companies are quoted on the Vilnius-based National Stock Exchange of Lithuania (NSEL). The NSEL lists comprise 55 companies, of which six are on the Official List and 49, on the Current List. At the end of April 2001 the capitalization of listed securities exceeded seven billion litas, while the capitalization of unlisted securities amounted to 6.4 billion litas.

The central market turnover remains fairly low. Since the beginning of 1996 only a few sessions have generated a turnover of listed securities in excess of one million litas (see diagram 1). The highest turnover was recorded in 1997 and 1998 when Lithuania's macroeconomic and corporate indicators were on the rise. As a rule, central market trading concentrates around several companies. Bock trades, which are concluded by securities intermediaries and used mainly for large share packages, account for about two thirds of the general share turnover.

Diagram 1. Share price indices and central market share turnover

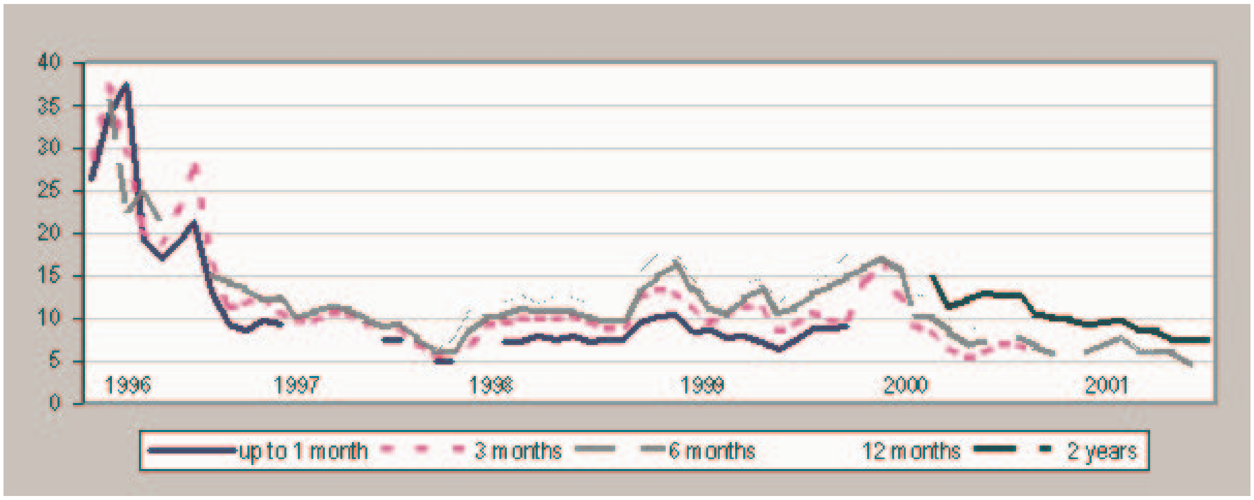


Source: National Stock Exchange of Lithuania

LITIN indices reflecting changes in share prices on the central market have been indicative of inert trading and a marked decline in the value of individual securities. LITIN G, reflecting changes in the prices of all listed securities, showed sizeable fluctuations in share prices in 1996 and 1997 (see diagram 1), but a decline and stabilisation followed. The index of the most liquid shares LITIN 10 has fluctuated inconsiderably, while the LITIN index of the Official List has dropped three times since it was launched.

In 2000 government securities constituted about 52 percent of the general turnover. Trading in government securities is conducted mainly by block trades.

Diagram 2. Interest rates on government securities



Source: Ministry of Finance

The yield of government securities (see diagram 2) has slumped markedly since 1996. The main reasons behind this decline have been reduced government borrowing, a stricter fiscal policy, investment ratings ranted to Lithuania and a decrease in LIBOR norms. Increased confidence on the part of investors, illustrated by a recent successful distribution of five- and seven-year government bonds denominated in litas, is another important factor.

Meanwhile corporate bonds comprise a rather negligible share of the securities market, accounting for a mere one percent of the general turnover. Still, there were some positive changes. In 2000 Lithuanian enterprises made nine bond issues, six of which were distributed in Lithuania. Among these companies were the Lithuanian Telecom, the Lithuanian Energy, the Lithuanian Gas and others. The maturity of most of these bonds was over one year. The yield comprised seven to twelve percent of the face value. All of these bond issues were non-public and unavailable to small investors.

Upturn in the economy bolsters the market

The improving economic situation is expected to bolster the securities market and the performance of Lithuanian companies. Last year's data already showed an upturn in the Lithuanian economy, and the results of the first quarter of this year seem to verify this trend. During the first quarter of 2001 the country's gross domestic product rose by 4.4 percent. Export increased by 23 percent, while import grew 16.9 percent. As the results of surveys show, market participants predict that GDP will grow by 4.0-4.2 percent in 2001.

The volume of sales of most companies quoted on the NSEL, except financial intermediaries, grew by about ten percent as compared with the past year. Excluding enterprises whose sales dropped, the volume of sales rose by 16 percent. Notably, this increase has not boosted the profitability of Lithuanian companies yet, but this may be attributed to fairly large depreciation costs related to capital investments. A macroeconomic survey conducted among market participants by the Lithuanian Free Market Institute shows that the profit margin is expected to reach 9.7 percent in 2002, a rise from 5.3 in 2000. It is anticipated that the improving macroeconomic situation will attract more local and domestic investors in the securities market.

The role of institutional investors

Institutional investors play an important role in boosting the liquidity of the securities market. In Lithuania commercial banks and insurance companies have so far invested mostly in government securities, while investments in equity have been rather negligible. However, a falling supply of, and yield on, government securities may bolster investments in equity.

Another important factor is that the Bank of Lithuania is going to gradually reduce the minimum reserve requirement until it reaches the level of two percent established in the European Union. In 2000 the Bank of Lithuania reduced the reserve requirement from ten to eight percent. This brought a fresh inflow of capital in the securities market and investments in equity.

Insurance companies are subject to certain restrictions on investments in corporate equity. Also, they are required to invest a certain share of authorised capital and technical reserves in government securities. These restrictions create distortions in the allocation of investments on the securities market and diminish the demand for equity. To ameliorate the situation, it is essential to remove these restrictions, providing that insurance companies invest authorised capital and technical reserves in line with the requirements of investment portfolio diversification.

Investment funds are minor players on the Lithuanian securities market. Until 2000 there were only investment holding companies operating in Lithuania. Their investments in equity accounted for a mere eight percent of total investments in equity. Investment holding companies are not allowed to issue redeemable shares. The first investment variable capital company was set up at the beginning of this year. Investment variable capital companies issue redeemable shares to attract small investors.

Strict authorised capital requirements and restrictions on investments abroad are the main reasons for the absence of investment variable capital companies. Investment funds are allowed to invest only in securities that are deemed liquid by the Securities Commission. These restrictions have led to establishing small investment funds that are not required to meet the said requirements.

Pension funds, which, as a rule, are major players on the securities market, are still non-existent in Lithuania. The legal basis for pension funds is in place, but the current social security policy appears to pose too serious an obstacle to their establishment. The Lithuanian pension system is based on the pay-as-you-go scheme and is mandatory for all working individuals. Fully funded pension insurance is optional and does not relieve its participants from contributing to the public pay-as-you-go system. The government of Lithuania is contemplating a pension reform that would introduce a three-pillar pension system. Under this system part of mandatory social security contributions would be directed to the social security fund, while the remaining share would go to pension funds. Optional fully funded insurance would be available as a supplemental component.

The beginning of the reform is scheduled for 2003, but the recent cabinet reshuffle has slowed the legislative debates. Besides, it is not clear yet what stand the new ruling majority will take. Still, tight budget constraints and Lithuania's aspirations to join the EU make it unlikely that the idea of mandatory fully funded pension insurance will be scrapped. The inflow of capital that the launch of compulsory fully funded pension insurance will bring is expected to considerably boost the securities market.

Investment opportunities are still too scarce

For the past several years the Lithuanian securities market has shown trends towards capital concentration. Hermis Bank, Vilnius Bank, the Lithuanian Savings Bank, Utenos and Švyturys breweries and other companies provide illustrative examples. After selling their controlling portfolios some of these companies have withdrawn from listed securities, while others have restructured or are going to reorganise into limited liability companies. On the other hand, these changes have been counterbalanced by the admittance of such companies as Ekranas, Vilniaus Vingis and Klaipėdos Baldai.

Still, today many companies find it more advantageous to attract capital through lending or non-public equity issues among the existing shareholders or own reserves. The main reasons for this are weaknesses in the legal basis for protection of large stockholders. The law requires, for example, that a company's documents containing confidential companies be available to all shareholders regardless of the amount of equity owned by them. Obviously, this diminishes the safety of investments and provides an open invitation to manipulating information. Admittedly, protection of small shareholders is not devoid of shortcomings either.

The effect of privatisation

Privatisation of state-owned shares in Lithuanian enterprises has been an important stimulus to the securities market. As a rule, privatisation bolsters the price of shares and releases additional equity on the securities market.

In June amendments were adopted to the Law on Public Securities Turnover, providing that investors who acquire a controlling share portfolio in a state-owned enterprise make an official offer to purchase the remaining shares. This provision is expected to heighten investors' interest in enterprises that are still in full or partial state ownership.

The main problems in the area of privatisation are related to the methods by which state property is sold. As a rule, the largest and the most attractive companies are sold not on the stock exchange (although the legal and institutional basis is in place), but through open auctions and direct negotiations. The application of these methods makes it possible to place artificial restrictions on potential investors, such as requirements regarding the origin of capital, qualifications, financial credibility, etc. The programme of the new government provides for expanding privatisation on the stock exchange in order to accelerate the development of the capital market. The future will show whether the new administration will live up to its promise.

Globalisation

Worldwide trends towards globalisation of securities markets and mergers of stock exchanges have not skipped Lithuania. Merging with other stock exchanges would create better opportunities for foreign investors to invest in Lithuania and for Lithuanian companies to attract more capital through new equity issues. Co-operation of the Baltic States led to the launch of a Baltic securities list at the beginning of 2000, comprising 15 largest companies from the Official Lists of the Tallinn, Riga and Vilnius stock exchanges. Also, in 2000 the three countries held negotiations on joining the NOREX alliance, but high costs of joining the alliance's infrastructure led them to halt the negotiations. The possibilities of joining other stock exchanges are being contemplated.

Litas peg to be replaced

Since 1994 the Lithuanian litas has been pegged to the U.S. dollar under a currency board system. The Bank of Lithuania has proclaimed that the litas will be re-pegged to euro on February 2, 2002 at the exchange rate of euro to the U.S. dollar announced by the European central bank on that day. It is instructive to note that both the Bank of Lithuania and the government have pledged to preserve the currency board regime until Lithuania joins the European Economic and Monetary Union.

For investors, knowing the circumstances of litas re-pegging and being certain about the continuity of the current monetary policy are crucial for revising their investment portfolios accordingly and avoiding possible pitfalls of exchange rate fluctuations.