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Pakistan: Trends & Developments

Mayhar Kazi, Shafaq Rehman,
Adil Tirmizey and Ayesha Siddique
RIAA Barker Gillette

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Trends and Developments

Contributed by:
Mayhar Kazi, Shafaq Rehman,
Adil Tirmizey and Ayesha Siddique
RIAA Barker Gillette see p.10

Introduction

Pakistan is fortunate in that its population has not been as severely impacted by COVID-19 as that of neighbouring countries. The federal and provincial governments have largely avoided imposing widespread lockdowns. The economy contracted slightly in the year ending 30 June 2020, rebounded to grow by 3.5% in the following year and is forecast by the Asian Development Bank to grow by 4% in the 2022 financial year.

Soon after the onset of the pandemic, a number of policies and incentives were introduced to stimulate economic activity. The central bank, the State Bank of Pakistan (SBP), drastically reduced interest rates and introduced a facility to provide concessionary refinancing for investment in new industrial units and/or expansion of existing units. A total amount of PKR435.7 billion was availed by hundreds of businesses under this facility.

Though large-scale manufacturing and exports (mainly of textiles and software) registered impressive growth, the Pakistani economy is currently experiencing increasing inflation and a widening trade deficit (even with rising exports), driven primarily by rising commodity prices. Following recovery, the central bank wound up monetary stimulus by raising interest rates to 9.75% in November 2021. In the same month, federal government reached a staff-level agreement with the IMF for resumption of the programme into which Pakistan entered in 2019. This is expected to stabilise the economy and reassure investors of the government's commitment to reforms required by the programme with respect to domestic revenue mobilisation, the power sector and greater autonomy for the central bank. Growth is expected to pick up further in the 2023 financial year.

Located on the crossroads of Central Asia, the Middle East and East Asia, Pakistan presents opportunities to investors in multiple sectors. With an improved security situation, relative to the 2000s and early 2010s, and investments in the 2010s in energy and transport infrastructure under the aegis of the China–Pakistan Economic Corridor (the flagship project of China's Belt and Road Initiative), Pakistan is attracting investment from major foreign investors. These include venture capital funds, manufacturers of automobiles and consumer electronics, and several major private and public sector players from neighbouring China.

This article will discuss notable recent investment trends in Pakistan in the context of related developments in law and policy which may be of interest to potential investors seeking to understanding the current Pakistani market.

Start-ups and Reforms to Facilitate Investment and Modernise the Regulatory Framework

Booming investment in start-ups

As the world's fifth-most populous country, with 63% of its people between the ages of 15 and 33, Pakistan is a significant market. With a large unbanked population, the country is amongst those with the lowest proportion of online consumer spending. Since 2018, the number of broadband connections has more than doubled to 110 million. These factors, together with historically low interest rates, has contributed to making Pakistan ripe for investments in tech start-ups.

Dubbed as “the world’s last big untapped nation” in the context of start-ups by Bloomberg, Pakistani start-ups raised funding of USD350+ million in the calendar year 2021, greater than the last six years combined. The majority of the investments have been made by venture capital funds, and in e-commerce, fintech and logistics. Some of the biggest names in the venture capital industry, including First Round Capital, Kleiner Perkins and Gobi Partners have already invested in the Pakistani start-ups. The largest single investment was received by Airlift Technologies, a technology start-up operating in logistics and quick commerce, by way of a series-B funding of USD85 million led by 20VC and Buckley Ventures. This was followed by e-commerce start-ups Bazaar, which serves as a B2B e-commerce marketplace for small retailers and offers a digital ledger, and Taajir, which also connects small retailers with suppliers.

The regulatory authorities most relevant to tech start-ups and fintech are: (i) the SBP, the central bank which, aside from the banking industry, also regulates Pakistan’s exchange control regime; and (ii) the Securities and Exchange Commission of Pakistan (SECP), which regulates companies, securities markets and the non-banking finance sector. The responsiveness of both regulators to the demands of investors in, and founders of, start-ups has been lauded across the industry. Noteworthy recent reforms and policy interventions are discussed below.

State Bank of Pakistan

The Foreign Exchange Manual (the “FE Manual”), is a compendium of general exemptions from the requirements of the Foreign Exchange Regulations Act, 1947 (FERA), which bars payments by persons in Pakistan to non-residents, except in accordance with a general or special exemption of the SBP. The FE Manual specifies the terms on which equity and debt financing may be raised by Pakistani businesses from non-residents in order for payments of dividends, sale proceeds, principal and interest to qualify for general exemption from the restrictions under the FERA. Pakistan has long had a liberal foreign exchange regime, which allows foreign investors freedom to repatriate profit and capital.

Holding companies

Recognising that some foreign investors desired to make equity investments in Pakistani start-ups and fintech companies indirectly (ie, through offshore holding companies), the SBP in February 2021 amended the FE Manual to allow founders to incorporate such holding companies. The approval stipulates that the holding company will hold shares in the Pakistani company on a repatriable basis, meaning that dividends and sale proceeds in respect of such shares will be allowed to be remitted in foreign exchange to the offshore holding company. Dividend and capital gains earned by Pakistani resident shareholders of the holding company are required to be repatriated to Pakistan and a specified portion of the funds raised by the holding company are required to be invested in shares of the Pakistani company. The permission to establish offshore holding companies is available in respect of Pakistani companies that have been incorporated for not more than seven years, have annual revenues of below PKR2 billion since incorporation and have less than PKR300 million in equity.

This reform measure allows Pakistani start-ups and fintech companies to receive equity investments from foreign investors whose mandate does not allow them to invest directly in Pakistan and those who have not undertaken extensive legal, tax and regulatory due diligence in Pakistan.

Convertible debt

The SBP published a working paper in early 2021, noting that the absence of a similar general permission for convertible debt hindered investment in early stage start-ups and led to lenders charging high interest to cover their risk. Thereafter, in May 2021, the SBP notified amendments to the FE Manual allowing Pakistani companies to obtain convertible loans with a maximum tenor of five years and specified borrowing costs. Borrowing companies are allowed to keep the loan proceeds in foreign currency accounts in Pakistan. Further, the loan may be converted into repatriable shares in the borrower on or before maturity. The eligibility criteria for companies that may obtain convertible debt is the same as that applicable to establishment of holding companies (see above).

This move to further liberalise Pakistan's exchange control regime will allow foreign investors the flexibility to adapt the nature of their investment to respond to the changing risk profile of start-ups as they scale and grow.

Digital banking

Branchless banking witnessed tremendous growth in Pakistan following the issuance of licences by the SBP in 2008. In order to further promote financial inclusion, reduce the cost of financial services and harness Pakistan's high smartphone penetration, the SBP has enacted a regulatory framework for the establishment and operation of digital banks, including deposit-taking and lending, which will be able to provide the whole host of banking services, including deposit taking and lending, entirely digitally.

In March 2021, the SBP published a draft Digital Bank Regulatory Framework which provides for the establishment and regulation of digital retail banks (DRB) and digital full banks (DFB), in the conventional and Islamic variants. Following the conclusion of the stakeholder consultation process, the final Digital Bank Regulatory Framework (the "Framework") was issued in early January 2022.. A wide range of persons are eligible to form DRBs, including international banks, experienced providers of digital financial solutions (DFS), electronic money institutions (EMI) licensed by the SBP and those having majority shares in or exercising control of such entities and microfinance banks.

The minimum capital requirement for DRBs is set at PKR1.5 billion during the pilot phase that will gradually increase to PKR4 billion over a transition period of three years. Subsequent to completion of the transition phase, DRBs may graduate to receive the licence of a DFB, subject to fulfilment of the minimum capital requirement and completion of a two-year progression phase.

The Framework envisages a five-stage licensing process, commencing with obtaining a no objection certificate from the SBP, progressing to operations readiness and pilot stages and culminating in commencement of commercial operations.

According to a press release on 3 January 2022, the SBP has decided to initially issue up to five digital bank licences, which essentially means that SBP is looking to attract players with a strong value proposition, a robust technological infrastructure, sufficient financial strength, technical expertise and an effective risk-management culture. Applications will be accepted until 31 March 2022.

Securities and Exchange Commission of Pakistan (SECP)

The SECP has undertaken a host of reform measures to modernise the regulatory framework for the corporate sector, improve access to capital markets, foster innovation and develop an entrepreneurship ecosystem in line with international best practices.

Start-ups

The recent amendments to the Companies Act, 2017 have authorised the SECP to make regulations to specify simplified procedures for easing the process of entry and exit for start-up companies, and to specify exemptions and incentives under prevailing laws.

Modernising regulation to allow greater flexibility to companies and shareholders

The recent amendments also enable all companies to offer stock options to their employees which was previously available only to public companies, and to buy back their shares, which was previously available only to listed companies respectively. To address impediments faced by the corporate sector, particularly start-ups and small companies, in raising equity through conventional modes, the amendment has expressly permitted all companies to raise share capital otherwise than by issuance of rights and for consideration other than in cash.

Lastly, the amendments have reduced to 5% the shareholding threshold for requisitioning an extraordinary general meeting of shareholders and provide that resolutions may be passed by the directors by circulation if signed by the majority of directors (instead of unanimously). The SECP has amended regulations to permit issuance of shares with different rights and privileges rights, without approval of the SECP. This move will considerably help reduce administrative burden and will contribute towards growth of new enterprises by removing a layer of regulatory approval.

Another vital amendment made by the SECP is to permit conversion of one class or kind of shares into another class or kind (eg, ordinary into preference shares). As per a press release of the SECP, this change aims to facilitate companies in maintaining an optimal capital structure considering their own financial needs and demands of their shareholders.

Improving access of SMEs, start-ups to capital markets through Growth Enterprise Market Board on the Pakistan Stock Exchange

Small and medium enterprises (SMEs) constitute nearly 90% of all enterprises in Pakistan. They contribute about 40% to the annual GDP and employ about 80% of the non-agricultural labour force. In collaboration with the Pakistan Stock Exchange, the SECP has introduced the listing regulations of the Growth Enterprise Market (GEM) Board to ease the process of raising capital through capital markets by SMEs, greenfield projects, start-ups, not-for-profit and other companies.

Designed for growth companies who have higher investment and liquidity risks, compared to the more established firms listed on the main board, the GEM Board is the second board on the Pakistan Stock Exchange for the listing and trading of equity securities, for which the pre-listing and post-listing requirements have been simplified, and costs of listing downscaled. Pak Agro Packaging Limited, an SME engaged in manufacturing of agricultural textile products, raised PKR198 million through the initial offering of its post-issue shares on the GEM Board. United Network Systems Limited, a tech-enabled logistics and e-commerce firm operating under the brand name of BlueEX, is the second listing on the GEM Board and has recently attracted equity financing of PKR445.7 million. With a rise in the number of start-ups in Pakistan, it is expected that the number of listings on the GEM Board will increase significantly in 2022.

Regulatory sandbox

To promote innovation in the financial sector, and encourage the growth of start-ups, the SECP introduced the concept of a "regulatory sandbox", which allows entities to conduct limited-scale live tests of innovative products, services, processes and business models, in a controlled environment. The purpose of this initiative is to assess market demand and assist in determining which new innovations should be introduced to the market for end users.

To govern this process, the SECP has issued the Regulatory Sandbox Guidelines, 2019. Several applicants have participated for inclusion in a cohort which is a complete life cycle of the regulatory sandbox implementation, where a set of applicants enter in order to ascertain the success of their innovation over a specified period of time.

The SECP has granted approval to various innovative solutions including parametric insurance, equity crowdfunding, real estate asset tokenisation, unified digital distribution of mutual fund application, digital identity/AML/KYC (AI-based) and centralised KYC under these guidelines. Approved applicants may live test their business models in a controlled environment for a period of up to six months.

At the end of the testing period, applicants are required to submit a comprehensive report to the SECP for sharing overall results and statistics, which will then determine the future course of action for these innovations. YPay, an autopilot for millennial investors which participated in the SECP regulatory sandbox, raised a seven-figure pre-seed investment at the end of 2021 through US-based accelerator fund On Deck.

The testing of technology-driven solutions through the regulatory sandbox is a welcome initiative which will stimulate financial and technological innovation and broaden the range of financial products. The number of applicants participating in cohorts is only expected to increase year-on-year, resulting in a rise in technology-driven financial products being made available to the Pakistani market.

Make in Pakistan

The federal government has adopted a "Make in Pakistan" policy to encourage investment in manufacturing to enable export-oriented industrialisation and import substitution. This has been necessitated by successive rounds of consumption-led economic growth over the years, which led to unsustainable trade deficits.

The recent depreciation of the local currency, which many experts believe was previously overvalued, is expected to help the case for investment in local manufacturing of previously imported goods. Earlier in 2021, the income tax legislation was amended to provide for tax credit for investment in capital investments in greenfield industrial undertakings engaged in manufacturing and shipbuilding, and by industrial undertakings engaged in the manufacture of plant and equipment for generation of renewable energy. There are also tax credits for investments in balancing, modernisation and replacement of plant and machinery by industrial undertakings.

Mobile phones

With a large and growing population, Pakistan is among the countries with the highest number of smartphone subscribers. The Mobile Device Manufacturing Policy, 2020, sought to incentivise the establishment of industry for the manufacture of mobile devices and offers a host of tax incentives, including:

- removal of regulatory duty for completely knocked down (CKD) and semi-knocked down (SKD) manufacturing under Input/ Output Co-Efficient Organization (IOCO) approved import authorisation;
- removal of fixed income tax on CKD/SKD manufacturing of mobile devices up to USD350 category;
- increase in fixed income tax on USD351,500 category by PKR2,000 and USD500 category by PKR6,300 on CKD/SKD manufacturing;
- removal of fixed sales tax on CKD/SKD manufacturing of mobile devices;
- research and development allowance of 3% for local manufacturers on the export of mobile phones; and
- exemption from 4% withholding tax on domestic sales of locally assembled/manufactured phones.

Customs duties on expensive imported mobile devices have been increased while those on cheaper ones have been reduced or eliminated. The Pakistan Telecommunication Authority, the telecoms regulator, issued the draft Mobile Device Manufacturing Regulations, 2021.

These initiatives led to Samsung Gulf Electronics Co. entering into a joint venture with Lucky Motor Corporation of Pakistan for production of Samsung mobile devices in Pakistan. Chinese manufacturers Infinix, Oppo, Vivo and Realme have already set up assembly plants in Pakistan, with Oppo having announced plans to upgrade its facility to a manufacturing plant and to export 5 million phones. Other companies – including Pakistani distributor Air Link, which in 2021 had the largest-ever IPO on the Pakistan Stock Exchange – are also establishing facilities to manufacture Xiaomi mobile devices in Pakistan.

Automotive industry

The federal government's Automotive Development Policy 2016–21, provided tax incentives for establishment of manufacturing plants. This led to new players including Hyundai, KIA and several Chinese manufacturers establishing assembly plants in Pakistan, where local production had previously been dominated by three major Japanese manufacturers. Earlier this year, the Volkswagen Group announced USD135 million investment for an assembly plant in Pakistan.

The Automotive Development Policy for 2021–26 was approved by the Cabinet in December 2021. This policy announces tax relief for automotive manufacturers, many of which came into effect in the Finance Act, 2021. With the exception of sales tax, which has been reduced, all other taxes and duties on locally manufactured vehicles having engines of less than 1,000CC. Excise duty on locally manufactured/assembled cars having larger engines has also been reduced.

Significantly, the new policy seeks to promote manufacture and import of electric and hybrid vehicles by reducing taxes and duties, and fixes export targets. In line with the federal government's "Make in Pakistan" agenda, the policy seeks to encourage local manufacturing of parts by excluding low value-added parts from the scope of tax concessions, and also sets targets by which parts currently imported will have to be locally manufactured. The policy aims for 100% of motorcycle parts and 75% of car parts to be locally manufactured by 2026.

Textile industry

The textile industry contributes the majority of Pakistan's export earnings and is the recipient of a host of tax and policy incentives and concessions from the federal government. The industry also received a substantial share of financing from the SBP's TERF scheme, which was announced as a stimulus package following the onset of the COVID-19 pandemic. This enabled the textile industry to place orders for import of reportedly USD3 billion worth of machinery to facilitate expansion. In October 2021, the All Pakistan Textile Mills Association announced that the industry will invest USD5 billion to build new manufacturing units. The investment has started to yield tangible results, with Pakistan's textile exports surging to an all-time high of USD6.04 billion during the period July–October 2021, an increase of nearly 27% year-on-year.

Public-Private Partnerships (PPPs)

Pakistan is extremely supportive of PPPs, at both the federal and provincial levels. While the energy sector has long been identified with successful PPP arrangements, such that it has attracted a range of international investors in both conventional and renewable power projects, the Pakistan government has also worked towards encouraging PPP arrangements in other areas including healthcare, education, technology, public transportation and even environmentally friendly slaughterhouses.

The federal government does not specify or restrict the form that the PPP interaction is to take (such as BOT versus BOOT). A 2021 policy instrument issued by the Planning Commission, the primary federal body responsible for earmarking funding for development projects, deemed its focus to be on supporting PPP initiatives through providing viability gap funding – ie, financial assistance in the form of grants by the state to projects that would otherwise have fallen below the financial viability threshold.

These positive steps taken by the federal government have resulted in several transportation projects, including the Sialkot–Kharian and Sukkur–Hyderabad roads, the Kharian–Rawalpindi Motorway, Karachi Circular Railway and Karachi–Pipri Freight Corridor worth over USD3.5 billion being identified as "early harvest projects" by the federal PPP authority.

Similar to the federal set-up, the provinces have established dedicated PPP authorities responsible for assessing, approving and implementing proposed PPP projects. Punjab has recently signed an MOU between the province's higher education department and private sector partners in launching a "chip designing tools" project that would provide jobs within both the education and IT sectors as well as approving the installation of smart water meters in the major metropolis of Lahore that would assist in reducing electricity bills for consumers. The Sindh government has recently signed an agreement with the IFC in developing Karachi's first greenfield water supply initiative, carried out under a PPP framework, which would ensure the supply of clean drinking water to 1 million people in the city.

Special Economic Zones

Both the federal government and the provincial governments are playing an active role in the development of special economic zones to promote export-oriented and import-substation industries. In particular, the Sindh government has recently awarded the development of the Dhabeji special economic zone to a private developer to be developed in the PPP mode. In KPK, the groundbreaking of the 1,000 acres Rakashai SEZ site (in Nowshera) took place earlier this year. The federal government promulgated a new law, the Special Technology Zones Authority Act, 2021, to facilitate the setting up of technology parks to harness the budding technology and software landscape in Pakistan. Under this law, eligible technology companies are permitted to benefit from tax holidays without the need to acquire physical space in a designated special technology zone or park.

In a similar vein, the Board of Approvals (set up under the Special Economic Zones Act, 2012) also enacted the Sole Enterprise Special Economic Zone Regulations, 2020 which allows eligible persons located in certain areas of Sindh to apply for a single greenfield project to get recognition as a zone enterprise without being located in an existing zone. This scheme has already attracted Servis Long Tyre March (who are setting up a multi-billion rupee tyre manufacturing facility), and Siddiqsons Tin Plate (which is setting up a multibillion rupee steel project). We expect many more investors to take advantage of the tax holidays under these regulations during the coming years.

Outlook

With improvements in the security situation – relative to the 2000s and early 2010s – and infrastructure, encouraging reforms by the regulators, and government's commitment to continuing reforms to facilitate investments and improve the ease of doing business, the investment outlook in Pakistan is optimistic. The rate of economic growth is expected to increase to 4%t in the next financial year with the implementation of key structural reforms, particularly those aimed at sustaining macroeconomic stability, increasing competitiveness and improving financial viability of the energy sector. There was a fear that recent instability in Afghanistan, resulting from the withdrawal of foreign troops, would spill over into Pakistan. However, the security situation has remained largely stable.

Large-scale manufacturing, software and start-ups are sectors that have performed well over the past year. Start-ups and fintechs have had attracted record investment this year, in what some believe may be a watershed moment for the country's tech ecosystem, including from players that did not traditionally view Pakistan as an investment destination. As they scale up across the country and potentially expand to other markets, as some already have, it is expected that the momentum will carry into 2022. With increasing awareness of the market, more investors are likely to invest in Pakistan and in areas beyond e-commerce, logistics and fintech.

RIAA Barker Gillette offers the full range of corporate, commercial and dispute resolution legal services from offices in Pakistan's major cities: Karachi, Lahore, Islamabad and Peshawar. With ten partners and over 50 associates, the firm is amongst the country's largest practices. Its clients include multinational corporations, financial institutions, non-profit organisations, Pakistani conglomerates, private clients and government agencies. RIAA Barker Gillette is also the primary Pakistan contact for many international law firms. It has extensive experience of complex, cross-border work, and on advising across a number of industry and regulatory sectors. The firm is routinely called on to act in projects, M&A, private equity, corporate restructuring and tax advisory mandates and on commercial disputes. In addition to the support and access to the resources of its offices in London, New York, Dubai, Beijing and Kabul, RIAA Barker Gillette is the exclusive member firm in Pakistan for Lex Mundi, the world's leading network of independent law firms with members in over 100 countries.

AUTHORS

Mayhar Kazi is a partner at RIAA Barker Gillette, based in Karachi. He represents clients in complex commercial disputes involving issues of arbitration, contract, company, energy, environment, insurance, shipping and tax law. Mayhar also advises on regulatory and tax advisory matters, and on corporate, competition, employment and investment law. His clients include major names in the banking, chemicals, commodities, consumer electronics, FMCG, insurance, management consultancy, petroleum, power and pharmaceutical industries, and he has extensively worked alongside major international law firms. Mayhar has written for Bloomberg's Tax Planning International Review, and has also contributed to the World Bank's Doing Business and Investing Across Borders publications.

Shafaq Rehman is a Karachi-based partner in the corporate practice of RIAA Barker Gillette. She advises corporate clients on investment matters, mergers and acquisitions, corporate and regulatory compliance, anti-competitive actions, data protection, tax and foreign exchange regulations. Shafaq is a key contact for major international law firms such as Baker McKenzie and Latham & Watkins for assistance with advising industry-leading multi-national clients on a wide range of Pakistan law-related matters. She is experienced in drafting, reviewing and negotiating various corporate and commercial contracts, including financing and security documentation. Shafaq has contributed extensively to leading international publications on M&A, investment and tax laws in Pakistan.

Contributed by: *Mayhar Kazi, Shafaq Rehman, Adil Tirmizey and Ayesha Siddique,* ***RIAA Barker Gillette***

Adil Tirmizey is a projects and corporate/commercial lawyer based in RIAA Barker Gillette's Lahore office. He advises on the full spectrum of project development, including shareholder arrangements, capital raising, licensing, off-take and government concession arrangements and commercial financing. Adil has recently advised on the PKR100 billion financing of an RLNG-based power project in Punjab. He has helped set up Pakistan's first privately owned housing finance company, and is currently supporting several technology start-ups benefitting from recent regulatory and tax incentives introduced for this sector by the Pakistan government.

Ayesha Siddique joined RIAA Barker Gillette in September 2021. She assists the firm's partners and senior associates in corporate and commercial transactions, and with opinions on corporate advisory matters.

RIAA Barker Gillette

D-67/1, Block 4
Clifton
Karachi
Pakistan

Tel: +92 21 111 529937
Email: pk@riaabg.com
Web: www.riaabarkergillette.com/pk

RIAA Barker Gillette