

Rating Research Services

Capital Securities Co. Ltd.

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Capital Securities Co. Ltd.

Major Rating Factors

Issuer Credit Rating

twA/Stable/twA-1

Strengths:

- Good capitalization relative to its risk position
- Satisfactory domestic market position in Taiwan's securities industry
- Adequate risk management, including market risk and credit risks

Weaknesses:

- Concentration on Taiwan's volatile stock market, despite diversification efforts
- Profitability sensitive to stock market volatility
- The constraint brought by wholesale funding profile.

Rationale

The ratings on **Capital Securities Co. Ltd.** reflect the company's good capitalization, satisfactory market position in Taiwan's securities industry, and adequate risk management. Counterbalancing factors on the ratings include the company's concentration on Taiwan's volatile stock market, profitability sensitive to stock market volatility, and the constraints brought by the company's wholesale funding profile.

In our view, Capital Securities' capitalization is good relative to its risk profile, due to stringent regulatory requirements and the company's adequate capital management. Capital Securities has maintained its leverage ratio, measured by total assets over total equity, at the industry average of 2x since it acquired **Taiwan International Securities Corp.** (TISC; not rated) in May 2011. Following the company's recent de-risking strategy, we expect it to remain prudent in its business expansion and maintain its financial leverage below 3x even when the stock market turns favorable. This capitalization is adequate to support the company's business growth over the next one to two years, in our opinion.

Capital Securities has a satisfactory market position in traditional brokerage business, which enables it to enjoy better scale advantages and secure a good business flow in margin lending business. The company ranks among the top four brokers in Taiwan by market share after it acquired TISC. Its market share in brokerage and margin lending business increased to about 5.7% and 7.7%, respectively, as of the first quarter of 2012, up from 3.9% and 5.1%, respectively, before the acquisition. Capital Securities is also one of the leading warrant /structured notes issuers in Taiwan.

Capital Securities' risk management framework remains adequate for both credit and market risks, in our view. Despite its higher investment in corporate bonds than its peers', we expect the company to manage its credit risk prudently, particularly on single-name exposures. We also view the company's overall market risk management as adequate thanks to its manageable risk appetite as well as proactive risk control skill including the stock proprietary trading and derivative trading business.

In our assessment, Capital Securities' business concentration in Taiwan's volatile stock market is unlikely to change in the next one to two years. About 85% of its adjusted revenue (adjusted for interest expense) was from domestic stock brokerage business and risk position taking over the past three years. In view of the fierce competition in domestic and overseas market, we don't expect new business development to make a significant contribution for some time, despite the company's efforts on wealth management development and overseas expansion including in Hong Kong.

Capital Securities' profitability remains volatile and sensitive to the cyclicity in Taiwan's stock market given its business concentration there. The company's return on average assets was 1.36% in 2011, a decline from 2.96% in 2010 and 5.72% in 2009. This was due to effect of an unfavorable stock market. We expect the volatility of Capital Securities' profitability to remain in the coming two to three years until the company makes significant progress on product and geographic diversification.

Capital Securities' high reliance on wholesale funding, which is a common feature of its domestic peers, continues to expose the company to the risk of drastic changes in interest rates and market liquidity in terms of funding cost and stability. The company's wholesale funding sources are mostly short-term and account for one-third of its total assets. Nonetheless, we expect the company to be able to manage its assets profile at a liquid level to moderate this issue.

Enterprise risk management

Capital Securities' enterprise risk management (ERM) is adequate, in our opinion. The company has demonstrated a prudent appetite toward risk raking and product complexity over the past two years. Similar with other industry players, the company has centralized its risk management within its risk department and asset allocation is distributed via a top-down approach after consideration of the company's overall risks. We believe the company has proactive risk control and prudently manages its concentration risk.

Outlook

The stable outlook reflects our expectation that Capital Securities will maintain its adequate capitalization without a material change in its risk profile over the next two to three years. We may raise the rating on Capital Securities if the company can significantly improve its profitability stability to be above industry average via meaningful business diversification and a better market position in core business. Conversely, we may lower the rating if the company's capitalization

weakens, as indicated by its leverage multiple rising above 3x, which could result from aggressive risk asset growth or a significant operation loss.

Related Criteria And Research

- Understanding TRC Rating Definitions, www.taiwanratings.com, Aug. 6, 2010
- A Roadmap For Evaluating Financial Institutions' ERM Practices, May 3, 2007
- Rating Securities Companies, June 9, 2004

(Unless otherwise stated, these articles are published on www.standardandpoors.com, access to which requires a registered account)

Table 1

Capital Securities Co. Ltd. Profitability Ratios

(Mil. NT\$)	--Year ended December 31--				
	2012*	2011	2010	2009	2008
Net interest income/operating revenues	18.5	24.6	22.7	15.1	(26.3)
Fee income/operating revenues	52.7	60.3	54.4	46.2	(63.5)
Market-sensitive income/operating revenues	16.6	0.3	11.3	30.2	199.2
Personnel expenses/operating revenues (%)	41.9	36.9	31.6	27.4	(38.8)
Noninterest expenses/operating revenues (%)	67.6	76.1	61.3	51.8	(80.8)
New loan loss provisions/operating revenues (%)	0.0	0.2	0.1	0.1	(0.2)
Operating income after loss provisions/operating revenues (%)	32.4	23.7	38.5	48.1	181.0
Pretax profit/operating revenues (%)	32.4	23.7	39.3	48.1	181.0
Tax/pretax profit (%)	15.7	36.5	28.6	24.0	18.2
Core earnings/operating revenues (%)	27.3	15.0	27.3	36.6	148.0
Core earnings/average adjusted net assets (%)	3.6	1.5	3.0	6.0	(11.3)
Noninterest expenses/average adjusted net assets (%)	8.8	7.4	6.8	8.4	6.2
Core earnings/average regulatory risk-weighted assets (%)	N.M.	N.M.	N.M.	N.M.	N.M.
Core earnings/average adjusted common equity (%)	7.0	3.1	6.8	14.3	(29.7)
Pretax profit/average common equity	7.3	4.5	9.7	18.3	(35.5)

NT\$--new Taiwan dollar. *Data are as of March 31st. N.M.--Not meaningful. Note: Ratios for 2012 are annualized.

Table 2

Capital Securities Co. Ltd. Capital Ratios

	--Year ended December 31--				
	2012*	2011	2010	2009	2008
Adjusted total equity/managed assets (%)	40.9	38.7	20.5	32.9	34.1
Common dividend payout ratio (%)	0.0	0.0	42.6	7.4	0.0

*Data are as of March 31st. Note: Ratios for 2012 are annualized.

Table 3

Capital Securities Co. Ltd. Summary Balance Sheet

(Mil. NT\$)	--Year ended December 31--				
	2012*	2011	2010	2009	2008
Assets					
Cash and money market instruments	5,245	6,649	4,452	5,277	5,858
Securities	16,615	16,422	15,944	15,395	15,621
Trading securities (marked to market)	15,730	15,247	14,844	14,695	14,857
Nontrading securities	885	1,175	1,101	700	764
Mortgage-backed securities included above	0	0	0	0	0
Loans to banks (net)	N/A	N/A	N/A	N/A	N/A
Receivables (gross)	0	0	0	0	0
Loan loss reserves	0	0	0	0	0
Receivables (net)	0	0	0	0	0
Earning assets	16,780	17,063	16,658	17,724	19,351
Equity interests/participations (nonfinancial)	0	0	0	0	0
Investments in unconsolidated subsidiaries (financial companies)	2,965	3,059	14,958	2,921	2,872
Intangibles (nonservicing)	3,540	3,541	393	390	390
Interest-only strips	N/A	N/A	N/A	N/A	N/A
Fixed assets	5,851	6,030	4,021	4,053	4,075
Derivatives credit amount	0	0	0	0	0
Accrued receivables	19,346	19,323	20,927	18,236	7,834
All other assets	2,181	2,533	1,498	2,828	3,300
Total assets	55,743	57,557	62,193	49,099	39,950
Intangibles (nonservicing)	3,540	3,541	393	390	390
Less insurance statutory funds	N/A	N/A	N/A	N/A	N/A
Adjusted assets	52,202	54,015	61,801	48,709	39,560
Liabilities					
Total deposits	0	0	0	0	0
Noncore deposits	0	0	0	0	0
Core/customer deposits	0	0	0	0	0
Acceptances	N/A	N/A	N/A	N/A	N/A
Repurchase agreements	10,539	11,594	8,351	9,439	14,682
Other borrowings	5,387	3,272	15,277	8,963	1,622
Other credit reserves	N/A	N/A	N/A	N/A	N/A
Other liabilities	9,327	12,661	9,702	10,677	6,594
Total liabilities	26,515	28,740	34,172	29,575	22,958
Total equity	29,228	28,817	28,022	19,524	16,992
Limited life preferred and quasi equity	N/A	N/A	N/A	N/A	N/A
Preferred stock and other capital	N/A	N/A	N/A	N/A	N/A
Mandatorily convertible securities	N/A	N/A	N/A	N/A	N/A
Enhanced trust preferred	N/A	N/A	N/A	N/A	N/A
Government-owned hybrids included in TAC without limit	N/A	N/A	N/A	N/A	N/A
Minority interest-equity	N/A	N/A	N/A	N/A	N/A
Common shareholders' equity	29,228	28,817	28,022	19,524	16,992
Share capital and surplus	26,426	26,426	25,655	16,905	17,113
Revaluation reserve	(70)	(37)	(58)	74	114
Retained profits	2,872	2,428	2,424	2,545	(121)
Other equity	0	0	0	0	(115)
Total liabilities and equity	55,743	57,557	62,193	49,099	39,950

NT\$--new Taiwan dollar. *Data are as of March 31st. N/A--Not applicable. Note: Ratios for 2012 are annualized.

Table 4

Capital Securities Co. Ltd. Equity Reconciliation Table

(Mil. NT\$)	--Year ended December 31--				
	2012*	2011	2010	2009	2008
Common shareholders' equity	29,228	28,817	28,022	19,524	16,992
Plus minority interest (equity)	0	0	0	0	0
Minus dividends (not yet distributed)	0	0	0	0	0
Minus revaluation reserves	70	37	58	(74)	(114)
Minus nonservicing intangibles	(3,540)	(3,541)	(393)	(390)	(390)
Minus interest-only strips (net)	N/A	N/A	N/A	N/A	N/A
Minus tax loss carryforwards	0	0	0	0	0
Minus postretirement benefit adjustments	0	0	0	0	0
Minus cumulative effect of credit-spread related revaluation of liabilities	N/A	N/A	N/A	N/A	N/A
Minus other adjustments	0	0	0	0	0
Adjusted common equity	25,757	25,312	27,687	19,061	16,487
Plus admissible preferred and hybrids	0	0	0	0	0
Total Adjusted Capital	25,757	25,312	27,687	19,061	16,487
Plus general reserves	0	0	0	0	0
Plus unrealized gains	0	0	0	0	0
Minus equity in unconsolidated subsidiaries	(2,965)	(3,059)	(14,958)	(2,921)	(2,872)
Minus capital of insurance subsidiaries	0	0	0	0	0
Minus adjustment for securitized assets	0	0	0	0	0
Adjusted total equity	22,792	22,254	12,729	16,140	13,615

NT\$--new Taiwan dollar. *Data are as of March 31st. N/A--Not applicable. Note: Ratios for 2012 are annualized.

Table 5

Capital Securities Co. Ltd. Profit And Loss

(Mil. NT\$)	--Year ended December 31--				
	2012*	2011	2010	2009	2008
Net interest income	301	1,335	1,330	1,050	1,038
Interest income	330	1,564	1,482	1,149	1,619
Interest expense	30	229	152	99	582
Operating noninterest income	1,327	4,081	4,532	5,907	(4,985)
Fees and commissions	857	3,268	3,187	3,213	2,505
Net brokerage commissions	790	2,802	2,688	2,998	2,347
Trading gains	117	(823)	180	1,565	(7,614)
Other market-sensitive income	153	838	480	533	(248)
Net insurance income	N/A	N/A	N/A	N/A	N/A
Equity in earnings of unconsolidated subsidiaries	N/A	N/A	N/A	N/A	N/A
Other noninterest income	199	798	685	597	372
Operating revenues	1,628	5,416	5,863	6,958	(3,947)
Noninterest expenses	1,101	4,124	3,596	3,601	3,190
Personnel expenses	683	1,999	1,855	1,910	1,530
Other general and administrative expense	314	1,731	1,410	1,357	1,360
Preprovision operating income	527	1,292	2,266	3,357	(7,137)
Credit loss provisions (net new)	0	10	8	9	8
Operating income after loss provisions	527	1,283	2,258	3,347	(7,144)

NT\$--new Taiwan dollar. *Data are as of March 31st. N/A--Not applicable. Note: Ratios for 2012 are annualized.

Table 5

Capital Securities Co. Ltd. Profit And Loss (cont'd)

(Mil. NT\$)	--Year ended December 31--				
	2012*	2011	2010	2009	2008
Nonrecurring/special income	0	0	46	0	0
Nonrecurring/special expense	N/A	N/A	N/A	N/A	N/A
Amortization of intangibles	N/A	N/A	N/A	N/A	N/A
Impairment of intangibles	N/A	N/A	N/A	N/A	N/A
Pretax profit	527	1,283	2,304	3,347	(7,144)
Tax expense/credit	83	468	659	802	(1,303)
Net income (before minority interest)	444	814	1,646	2,545	(5,841)
Minority interest in consolidated subsidiaries	N/A	N/A	N/A	N/A	N/A
Net income before extraordinary	444	814	1,646	2,545	(5,841)
Net income after extraordinary	444	814	1,646	2,545	(5,841)

NT\$--new Taiwan dollar. *Data are as of March 31st. N/A--Not applicable. Note: Ratios for 2012 are annualized.

Table 6

Capital Securities Co. Ltd. Core Earnings Reconciliation Table

(Mil. NT\$)	--Year ended December 31--				
	2012*	2011	2010	2009	2008
Net income (before minority interest)	444	814	1,646	2,545	(5,841)
Minus nonrecurring/special income	0	0	(46)	0	0
Plus nonrecurring/special expense	N/A	N/A	N/A	N/A	N/A
Plus or minus tax impact of adjustments	0	0	0	0	0
Plus amortization/impairment of goodwill/intangibles	0	0	0	0	0
Minus preferred dividends	0	0	0	0	0
Plus or minus other earnings adjustments	0	0	0	0	0
Core earnings	444	814	1,600	2,545	(5,841)

NT\$--new Taiwan dollar. *Data are as of March 31st. N/A--Not applicable. Note: Ratios for 2012 are annualized.

Ratings Detail

TRC Current Ratings	Issuer Credit Rating	twA/Stable/twA-1
Credit Rating History	2010/06/23	twA/Stable/twA-1
	2009/09/16	twA-/Positive/twA-2
	2009/02/25	twA-/Stable/twA-2
	2008/10/28	twA-/Watch Neg/twA-1
	2008/10/8	twA-/Negative/twA-1
	2007/06/07	twA-/Stable/twA-1
	2006/09/13	twA-/Stable/twA-2

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