

# Rating Research Services

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## Capital Securities Corp.

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# Capital Securities Corp.

## Issuer Credit Rating

twA/Stable/twA-1

## Major Rating Factors

### 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.
- Somewhat volatile profitability compared with global peers.
- High reliance on wholesale funding.

## Rationale

The ratings on **Capital Securities Corp.** 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, somewhat volatile profitability compared with its global peers, and high reliance on wholesale funding.

In our view, Capital Securities' capitalization is good relative to its risk profile, as a result of its stringent regulatory requirements and the company's adequate capital management and risk appetite. Capital Securities has maintained its leverage ratio, measured by total assets over total equity, at the industry average of 2x over the past two years, thanks to its moderate risk asset growth. We expect the company to maintain its prudent business expansion and sustain its financial leverage below 3x even when the stock market turns favorable.

We believe Capital Securities has a satisfactory market position in traditional brokerage business, which enables it to benefit from better scale advantages than its peers and secure good business flow in margin-lending business. The company ranks among the top four brokers in Taiwan by market share after it acquired Taiwan International Securities Corp. The acquisition bolstered Capital Securities' market share in brokerage and margin-lending business to about 5.4% and 7.5%, respectively, in 2012, up from about 4% and 5% before the acquisition. Capital Securities is also one of the leading warrant/structured notes issuers in Taiwan.

In our view, Capital Securities' risk management framework remains adequate for both credit and market risks. The company has maintained an adequate risk appetite on market risk with proactive risk control skill, particularly on stock proprietary trading and derivative-trading business. This

prevented the company from significant trading losses when the stock market turned unfavorable during the past two years. In addition, we expect Capital Securities to manage its credit risk prudently, particularly the diversification in its corporate bonds portfolio, which the company has increased quite significantly over the past few quarters.

In our view, Capital Securities' business and revenue source is likely to remain concentrated in Taiwan's volatile stock market in the next two years. This is despite the company's efforts on new business development, including wealth management and overseas expansion. Over 80% of its adjusted revenue (adjusted for interest expense) still came from business related to the domestic stock market, including stock brokerage and risk position taking.

Capital Securities' profitability remains somewhat volatile compared with global peers, mainly due to its high sensitivity to Taiwan's volatile stock market. The company's return on average assets rose above 5% in 2009 but later fell below 2% due to the unfavorable domestic stock market. We expect Capital Securities' profitability to remain volatile in the coming two years, before the company makes significant progress on product and geographic diversification.

Capital Securities is highly reliant on wholesale funding, similar to other domestic peers. This weakness exposes the company to some risk of funding stability and funding cost, if there were drastic changes in interest rates and market liquidity. The company's wholesale funding, accounts for one-third of its total assets and is mostly short-term funding. Nonetheless, Capital Securities' liquid assets profile may moderate this weakness to some extent.

### **Enterprise risk management**

Capital Securities' enterprise risk management (ERM) is adequate, in our opinion. The company has demonstrated a prudent appetite toward risk taking 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 risk consideration.

## **Outlook**

The stable outlook reflects our expectation that Capital Securities will maintain its good capitalization through the pursuit of a prudent growth strategy over the next one to two years. We also expect its risk profile to remain manageable based on its prudent risk appetite. We may raise the rating on Capital Securities if the company can significantly improve its profitability to be consistently above the domestic industry average, in terms of quality and stability, via meaningful business diversification and stronger market position. 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

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**Table 1**

### Capital Securities Corp. Profitability Ratios

(Mil. NT\$)	--Year ended December 31--				
	2012	2011	2010	2009	2008
Net interest income/operating revenues (%)	20.8	24.6	22.7	15.1	(26.3)
Fee income/operating revenues (%)	52.9	60.3	54.4	46.2	(63.5)
Market-sensitive income/operating revenues (%)	8.2	0.3	11.3	30.2	199.2
Personnel expenses/operating revenues (%)	39.6	36.9	31.6	27.4	(38.8)
Noninterest expenses/operating revenues (%)	75.5	76.1	61.3	51.8	(80.8)
New loan loss provisions/operating revenues (%)	0.1	0.2	0.1	0.1	(0.2)
Operating income after loss provisions/operating revenues (%)	24.3	23.7	38.5	48.1	181.0
Pretax profit/operating revenues (%)	24.3	23.7	39.3	48.1	181.0
Tax/pretax profit (%)	16.6	36.5	28.6	24.0	18.2
Core earnings/operating revenues (%)	20.3	15.0	27.3	36.6	148.0
Core earnings/average adjusted net assets (%)	2.1	1.5	3.0	6.0	(11.3)
Noninterest expenses/average adjusted net assets (%)	7.9	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 (%)	4.1	3.1	6.8	14.3	(29.7)
Pretax profit/average common equity (%)	4.4	4.5	9.7	18.3	(35.5)

NT\$--New Taiwan dollar. N.M.--Not meaningful.

**Table 2**

### Capital Securities Corp. Capital Ratios

	--Year ended December 31--				
	2012	2011	2010	2009	2008
Adjusted total equity/managed assets (%)	42.0	38.7	20.5	32.9	34.1
Common dividend payout ratio (%)	0.0	72.7	42.6	7.4	0.0

NT\$--New Taiwan dollar.

Table 3

## Capital Securities Corp. Summary Balance Sheet

(Mil. NT\$)	--Year ended December 31--				
	2012	2011	2010	2009	2008
<b>Assets</b>					
Cash and money market instruments	7,241	6,644	4,452	5,277	5,858
Securities	15,949	16,427	15,944	15,395	15,621
Trading securities (marked to market)	15,094	15,252	14,844	14,695	14,857
Nontrading securities	854	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	17,062	17,067	16,658	17,724	19,351
Equity interests/participations (nonfinancial)	0	0	0	0	0
Investments in unconsolidated subsidiaries (financial companies)	2,914	3,059	14,958	2,921	2,872
Intangibles (nonservicing)	3,536	3,541	393	390	390
Interest-only strips	N/A	N/A	N/A	N/A	N/A
Fixed assets	5,761	6,030	4,021	4,053	4,075
Derivatives credit amount	0	0	0	0	0
Accrued receivables	16,687	19,323	20,927	18,236	7,834
All other assets	2,316	2,533	1,498	2,828	3,300
Total assets	54,403	57,557	62,193	49,099	39,950
Intangibles (nonservicing)	3,536	3,541	393	390	390
Less insurance statutory funds	N/A	N/A	N/A	N/A	N/A
Adjusted assets	50,868	54,015	61,801	48,709	39,560
<b>Liabilities</b>					
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	11,329	11,594	8,351	9,439	14,682
Other borrowings	1,444	3,272	15,277	8,963	1,622
Other credit reserves	N/A	N/A	N/A	N/A	N/A
Other liabilities	10,709	12,661	8,831	10,677	6,594
Total liabilities	25,277	28,740	34,172	29,575	22,958
Total equity	29,127	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	0	0	0	0	0
Common shareholders' equity	29,127	28,817	28,022	19,524	16,992
Share capital and surplus	26,426	26,426	25,655	16,905	17,113
Revaluation reserve	(173)	(37)	(58)	74	114
Retained profits	2,874	2,428	2,424	2,545	(121)
Other equity	0	0	0	0	(115)
Total liabilities and equity	54,403	57,557	62,193	49,099	39,950

NT\$--New Taiwan dollar. N/A--Not applicable.

Table 4

## Capital Securities Corp. Equity Reconciliation Table

(Mil. NT\$)	--Year ended December 31--				
	2012	2011	2010	2009	2008
Common shareholders' equity	29,127	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	173	37	58	(74)	(114)
Minus nonservicing intangibles	(3,536)	(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	25,764	25,312	27,687	19,061	16,487
Plus admissible preferred and hybrids	0	0	0	0	0
Total Adjusted Capital	25,764	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	(2,914)	(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	22,851	22,254	12,729	16,140	13,615

NT\$--New Taiwan dollar. N/A--Not applicable.

Table 5

## Capital Securities Corp. Profit And Loss

(Mil. NT\$)	--Year ended December 31--				
	2012	2011	2010	2009	2008
Net interest income	1,081	1,335	1,330	1,050	1,038
Interest income	1,230	1,564	1,482	1,149	1,619
Interest expense	149	229	152	99	582
Operating noninterest income	4,120	4,081	4,532	5,907	(4,985)
Fees and commissions	2,750	3,268	3,187	3,213	2,505
Net brokerage commissions	2,375	2,802	2,688	2,998	2,347
Trading gains	31	(823)	180	1,565	(7,614)
Other market-sensitive income	394	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	944	798	685	597	372
Operating revenues	5,201	5,416	5,863	6,958	(3,947)
Noninterest expenses	3,929	4,124	3,596	3,601	3,190
Personnel expenses	2,057	1,999	1,855	1,910	1,530
Other general and administrative expense	1,519	1,731	1,399	1,357	1,360
Preprovision operating income	1,272	1,292	2,266	3,357	(7,137)
Credit loss provisions (net new)	8	10	8	9	8
Operating income after loss provisions	1,265	1,283	2,258	3,347	(7,144)
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

**Capital Securities Corp. Profit And Loss (cont'd)**

(Mil. NT\$)	--Year ended December 31--				
	2012	2011	2010	2009	2008
Pretax profit	1,265	1,283	2,304	3,347	(7,144)
Tax expense/credit	210	468	659	802	(1,303)
Net income (before minority interest)	1,054	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 extraordinaries	1,054	814	1,646	2,545	(5,841)
Net income after extraordinaries	1,054	814	1,646	2,545	(5,841)

NT\$--New Taiwan dollar. N/A--Not applicable.

**Table 6****Capital Securities Corp. Core Earnings Reconciliation Table**

(Mil. NT\$)	--Year ended December 31--				
	2012	2011	2010	2009	2008
Net income (before minority interest)	1,054	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	1,054	814	1,600	2,545	(5,841)

NT\$--New Taiwan dollar. N/A--Not applicable.

**Ratings Detail**

TRC Current Ratings	Issuer Credit Rating	twA/Stable/twA-1
Issuer 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/WatchNeg/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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