

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 market position in Taiwan's securities industry.
- Adequate risk management, including market risk and credit risks.

Weaknesses:

- Concentration in 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 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, somewhat volatile profitability compared with its global peers, and high reliance on wholesale funding.

In our view, Capital Securities has good capitalization 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 three years, thanks to its moderate risk asset growth. The slight increase in leverage in 2013 was driven by an accounting change yet still compared favorably with the industry average. 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's brokerage market share declined to below 5% in 2013, which brought down its market rank to fifth. This was due to increased trading by foreign investors who mostly deal with foreign-based brokers, plus Capital Securities' strategy to avoid price competition with its domestic peers. We expect the company to maintain its brokerage market share going forward. We also expect Capital Securities to maintain its competitive advantage as one of the leading warrant/structured notes issuers and bond and equity underwriters in Taiwan.

In our view, Capital Securities' risk management framework remains adequate for 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 Capital Securities from significant trading losses during the stock market's unfavorable period over the past three years.

In our view, Capital Securities' business and revenue source is likely to remain concentrated in Taiwan's volatile stock market over the next two years. This is despite the company's efforts to develop new business, including wealth management and overseas expansion. Over 80% of its adjusted revenue (adjusted for interest expense) still comes from 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 has since fallen 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 its 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 moderates this weakness to some extent.

Enterprise risk management

Capital Securities' enterprise risk management 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 over the next one to two years. We also expect the company's risk profile to remain manageable based on its prudent risk appetite. The outlook also reflects our view that Capital Securities' earnings will likely remain volatile and in line with the industry average with high reliance on Taiwan's stock market.

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

Related Criteria

- **Understanding TRC Rating Definitions, www.taiwanratings.com, Oct. 29, 2013**
- **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					
	--Year-ended Dec. 31--				
(Mil. NT\$)	2013	2012	2011	2010	2009
Net interest income/operating revenues	20.0	20.8	24.6	22.7	15.1
Fee income/operating revenues	50.8	52.9	60.3	54.4	46.2
Market-sensitive income/operating revenues	11.5	8.2	0.3	11.3	30.2
Personnel expenses/operating revenues (%)	41.3	39.6	36.9	31.6	27.4
Noninterest expenses/operating revenues (%)	69.4	75.5	76.1	61.3	51.8
New loan loss provisions/operating revenues (%)	0.0	0.1	0.2	0.1	0.1
Operating income after loss provisions/operating revenues (%)	30.6	24.3	23.7	38.5	48.1
Pretax profit/operating revenues (%)	30.6	24.3	23.7	39.3	48.1
Tax/pretax profit (%)	10.7	16.6	36.5	28.6	24.0
Core earnings/operating revenues (%)	27.3	20.3	15.0	27.3	36.6
Core earnings/average adjusted net assets (%)	2.7	2.1	1.5	3.0	6.0
Noninterest expenses/average adjusted net assets (%)	6.8	7.9	7.4	6.8	8.4
Core earnings/average regulatory risk-weighted assets (%)	N.M.	N.M.	N.M.	N.M.	N.M.
Core earnings/average adjusted common equity (%)	5.6	4.1	3.1	6.8	14.3
Pretax profit/average common equity	5.6	4.4	4.5	9.7	18.3
NT\$--New Taiwan dollar. N.M.--Not meaningful.					

Table 2

Capital Securities Corp. Capital Ratios					
	--Year-ended Dec. 31--				
	2013	2012	2011	2010	2009
Adjusted total equity/managed assets (%)	34.6	42.0	38.7	20.5	32.9
Common dividend payout ratio (%)	N/A	33.7	72.7	42.6	7.4

N/A--Not applicable.

Table 3

Capital Securities Corp. Summary Balance Sheet

	--Year-ended Dec. 31--				
(Mil. NT\$)	2013	2012	2011	2010	2009
Assets					
Cash and money market instruments	4,894	7,241	6,644	4,452	5,277
Securities	21,760	15,949	16,427	15,944	15,395
Trading securities (marked to market)	20,915	15,094	15,252	14,844	14,695
Nontrading securities	845	854	1,175	1,101	700
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	22,213	17,062	17,067	16,658	17,724
Equity interests/participations (nonfinancial)	0	0	0	0	0
Investments in unconsolidated subsidiaries (financial companies)	3,128	2,914	3,059	14,958	2,921
Intangibles (nonservicing)	3,544	3,536	3,541	393	390
Interest-only strips	N/A	N/A	N/A	N/A	N/A
Fixed assets	5,644	5,761	6,030	4,021	4,053
Derivatives credit amount	0	0	0	0	0
Accrued receivables	25,678	16,687	19,323	20,927	18,236
All other assets	2,977	2,316	2,533	1,498	2,828
Total assets	67,624	54,403	57,557	62,193	49,099
Intangibles (nonservicing)	3,544	3,536	3,541	393	390
Less insurance statutory funds	N/A	N/A	N/A	N/A	N/A
Adjusted assets	64,080	50,868	54,015	61,801	48,709
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	13,115	11,329	11,594	8,351	9,439
Other borrowings	4,319	1,444	3,272	15,277	8,963
Other credit reserves	N/A	N/A	N/A	N/A	N/A
Other liabilities	20,143	12,504	13,874	10,544	11,173
Total liabilities	37,576	25,277	28,740	34,172	29,575
Total equity	30,048	29,127	28,817	28,022	19,524
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	30,048	29,127	28,817	28,022	19,524
Share capital and surplus	26,396	26,426	26,426	25,655	16,905
Revaluation reserve	(7)	(173)	(37)	(58)	74
Retained profits	3,658	2,874	2,428	2,424	2,545
Other equity	0	0	0	0	0
Total liabilities and equity	67,624	54,403	57,557	62,193	49,099

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

Table 4

Capital Securities Corp. Equity Reconciliation Table					
	--Year-ended Dec. 31--				
(Mil. NT\$)	2013	2012	2011	2010	2009
Common shareholders' equity	30,048	29,127	28,817	28,022	19,524
Plus minority interest (equity)	0	0	0	0	0
Minus dividends (not yet distributed)	0	0	0	0	0
Minus revaluation reserves	7	173	37	58	(74)
Minus nonservicing intangibles	(3,544)	(3,536)	(3,541)	(393)	(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	26,511	25,764	25,312	27,687	19,061
Plus admissible preferred and hybrids	0	0	0	0	0
Total Adjusted Capital	26,511	25,764	25,312	27,687	19,061
Plus general reserves	0	0	0	0	0
Plus unrealized gains	0	0	0	0	0
Minus equity in unconsolidated subsidiaries	(3,128)	(2,914)	(3,059)	(14,958)	(2,921)
Minus capital of insurance subsidiaries	0	0	0	0	0
Minus adjustment for securitized assets	0	0	0	0	0
Adjusted total equity	23,383	22,851	22,254	12,729	16,140
NT\$--new Taiwan dollar. N/A--Not applicable.					

Table 5

Capital Securities Corp. Profit And Loss					
	--Year-ended Dec. 31--				
(Mil. NT\$)	2013	2012	2011	2010	2009
Net interest income	1,076	1,081	1,335	1,330	1,050
Interest income	1,209	1,230	1,564	1,482	1,149
Interest expense	134	149	229	152	99
Operating noninterest income	4,307	4,120	4,081	4,532	5,907
Fees and commissions	2,737	2,750	3,268	3,187	3,213
Net brokerage commissions	2,296	2,375	2,802	2,688	2,998
Trading gains	105	31	(823)	180	1,565
Other market-sensitive income	515	394	838	480	533
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	950	944	798	685	597
Operating revenues	5,383	5,201	5,416	5,863	6,958
Noninterest expenses	3,735	3,929	4,124	3,596	3,601
Personnel expenses	2,220	2,057	1,999	1,855	1,910
Other general and administrative expense	1,181	1,519	1,731	1,399	1,357
Preprovision operating income	1,648	1,272	1,292	2,266	3,357
Credit loss provisions (net new)	0	8	10	8	9
Operating income after loss provisions	1,648	1,265	1,283	2,258	3,347
Nonrecurring/special income	0	0	0	46	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	1,648	1,265	1,283	2,304	3,347
Tax expense/credit	176	210	468	659	802
Net income (before minority interest)	1,472	1,054	814	1,646	2,545

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

(Mil. NT\$)	--Year-ended Dec. 31--				
	2013	2012	2011	2010	2009
Minority interest in consolidated subsidiaries	N/A	N/A	N/A	N/A	N/A
Net income before extraordinary	1,472	1,054	814	1,646	2,545
Net income after extraordinary	1,472	1,054	814	1,646	2,545

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

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

(Mil. NT\$)	--Year-ended Dec. 31--				
	2013	2012	2011	2010	2009
Net income (before minority interest)	1,472	1,054	814	1,646	2,545
Minus nonrecurring/special income	0	0	0	(46)	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	1,472	1,054	814	1,600	2,545

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

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