

Rating Research Services

Full Analysis: Capital Securities Co. Ltd.

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Capital Securities Co. Ltd.

Issuer Credit Rating

twA/Negative/twA-1

Major Rating Factors

Strengths	Weaknesses
<ul style="list-style-type: none"> • Very strong capitalization. • Satisfactory market position in Taiwan's securities industry. 	<ul style="list-style-type: none"> • High reliance on wholesale funding • Revenue concentration in Taiwan's volatile stock market, despite the company's diversification efforts.

Outlook: Negative

The negative outlook reflects **Capital Securities Co. Ltd.**'s weakened ability to maintain adequate funding and liquidity in times of market stress. We expect the firm to lower its bond exposures over the short term in order to lower its potential funding and liquidity risks under stressed conditions. We also expect Capital Securities to maintain its very strong capital through the pursuit of a prudent growth strategy over the next one to two years. The company's earnings are likely to remain volatile and in line with the industry average, with a high reliance on Taiwan's stock market. Nonetheless, we believe Capital Securities will maintain its earnings quality and capacity, dominated by stable brokerage fee income and interest from margin lending.

Downside scenario

We may lower the rating on Capital Securities if the firm is unable to maintain its funding risks at an adequate level and restore its liquidity ratio to an adequate-low level over the coming year. This would mean the company cannot maintain its ratio of available stable funding relative to stable funding needs above 90% and a liquidity coverage metric below 0.9x.

Upside scenario

We may revise the outlook to stable if Capital Securities' funding and liquidity risks lower with signs of sustained improvement in its funding and liquidity metrics over the coming year. This may occur if the company reduces its bond exposures and sets a tighter limit for its tolerance on funding and liquidity measurement, increases its long-term borrowings or debts to match the investment exposure, or strengthens its capital and liquid assets.

Rationale

The ratings on Capital Securities reflect our view of the company's very strong capitalization and its stable business position in the domestic securities market. Counterbalancing these strengths is the company's high reliance on wholesale funding, which raises its funding and liquidity risk under stressed conditions as the company grows its investment portfolio. Capital

Securities' revenue concentration in Taiwan's stock market results in more volatile earnings compared with its international peers' and partly offsets the company's rating strengths.

Anchor: 'bb+' anchor for securities companies operating mainly in Taiwan

We believe that securities firms in Taiwan face higher economic risks than banks due to their focus on business in the volatile domestic equity market. We also regard the industry risk of Taiwan securities firms as being higher than that for banks, given the less-stable revenue base of securities companies, which tends to fluctuate with domestic stock market performance. In addition, Taiwan securities firms' reliance on wholesale funding is greater than for their banking counterparts which have retail and diversified funding sources. As a result, the anchor for Taiwan securities firms is 'bb+', which is two notches below the Taiwan bank anchor.

Table 1 | [Download Table](#)

Capital Securities Co. Ltd. Key Financial Data

	--Year-ended Dec. 31--				
(Mil. NT\$)	2016	2015	2014	2013	2012
Adjusted assets	104,457	89,725	80,121	74,366	61,572
Adjusted common equity	26,401	26,712	27,119	26,144	25,930
Total Adjusted Capital	26,401	26,712	27,119	26,144	25,930
Operating revenues	6,299	6,835	7,158	6,357	6,159
Noninterest expenses	4,627	4,801	4,725	4,563	4,750
Net income	1,406	1,728	2,144	1,573	1,146
Core earnings	1,406	1,728	2,144	1,573	1,146

NT\$--New Taiwan dollar.

Business position: Satisfactory market position with stable business mix

Capital Securities' adequate business position in Taiwan is underpinned by the company's stable business mix and revenues, and satisfactory market position in major product lines. The company ranks sixth in the domestic brokerage business with a market share of 4% as of end-2016. This enables Capital Securities to secure good business flow in margin-lending business. The company is also one of the leading warrant/structured notes issuers and bond and equity underwriters in Taiwan in terms of number of issuances and transactions. Capital Securities' stable business mix is dominated by traditional brokerage business which contributes the majority of the company's revenues.

In our view, Capital Securities has been performing satisfactorily over the past five years with a return on equities in line with the domestic industry average. However, we expect Capital Securities to remain highly sensitive to Taiwan's volatile stock market over the next two years. The majority of the company's business and revenue sources remain concentrated in the local market, given the large revenue contribution from stock brokerage. However, Capital Securities has made efforts to develop new businesses, including wealth management, bond trading, and expansion overseas.

Table 2 | [Download Table](#)**Capital Securities Co. Ltd. Business Position**

	--Year-ended Dec. 31--				
(%)	2016	2015	2014	2013	2012
Net interest income/operating revenues	18.7	17.9	17.7	17.1	17.6
Fee income/operating revenues	58.6	57.1	55.0	56.4	59.3
Market-sensitive income/operating revenues	7.0	11.3	12.5	11.1	7.2
Pretax profit/operating revenues	26.5	29.8	34.0	28.2	22.9
Core earnings/average adjusted common equity	5.3	6.4	8.0	6.0	4.5

Capital and earnings: Very strong relevant to its risk profile

We view Capital Securities' very strong capital as its greatest credit strength, which we expect it to maintain through prudent growth over the next two years. As of the end of 2016, the company's risk-adjusted capital ratio was well above 15%, our threshold for very strong capitalization. The quality of the company's capital is good, in our view, because it is comprised entirely of shareholders' equities. Capital Securities' earnings are adequate by local standards, but somewhat volatile compared to global peers' due to the sensitivity of local securities firms to Taiwan's stock market. We believe this sensitivity is unlikely to change until the company makes significant progress on product and geographic diversification. Nonetheless, the firm's capital provides a good buffer to absorb losses.

Table 3 | [Download Table](#)**Capital Securities Co. Ltd. Capital**

	--Year-ended Dec. 31--				
(%)	2016	2015	2014	2013	2012
Leverage Ratio (IFRS)	25.3	29.8	34.0	35.2	42.1
S&P RAC ratio before diversification	21.8	23.1	23.3	N.M.	N.M.
Adjusted total equity/adjusted assets	25.1	29.6	33.7	35.1	41.9
Adjusted common equity/total adjusted capital	100.0	100.0	100.0	100.0	100.0

N.M.--Not meaningful.

Table 4 | [Download Table](#)**Capital Securities Co. Ltd. Earnings**

	--Year-ended Dec. 31--				
(%)	2016	2015	2014	2013	2012
Personnel expenses/operating revenues	38.4	36.1	36.2	40.5	33.4
Cost-income ratio	73.5	70.2	66.0	71.8	77.1
Core earnings/operating revenues	22.3	25.3	29.9	24.8	18.6
Internal capital generation/prior year's equity	2.3	1.8	2.5	1.7	3.0
Net interest income/average earning assets	2.8	4.0	5.3	5.5	6.2

Risk position: Adequate risk appetite and risk control

In our view, Capital Securities' risk management framework is adequate for the company's credit and market risks. Credit risk on margin lending is well controlled, given the firm's non-performing loans ratio is below 1.5% and a high average coverage ratio of 170%. Capital Securities' bond holdings generally are of investment grade ratings and are diversified in terms of geography. The company has also maintained an adequate risk appetite on market risk with proactive risk control and stop loss mechanisms, particularly on stock proprietary trading and derivative-trading business. This has prevented significant trading losses during the stock market's unfavorable performance over the past three years and particularly during the market volatility seen at the end of 2015 and in early 2016.

Capital Securities' growth and changes in exposures are also satisfactory, in our view, given the company's shift in 2015 toward credit risk on bond trading and away from the more volatile market risk on equity trading. Capital Securities' risk taking still tends to fluctuate according to the local stock market performance, which is similar to its peers'. The company does not have major risk concentration and its operation remains somewhat simplistic.

Table 5 | [Download Table](#)

Capital Securities Co. Ltd. Risk Position					
	--Year-ended Dec. 31--				
(%)	2016	2015	2014	2013	2012
Annualized adjusted assets growth rate	16.4	12.0	7.7	20.8	(4.2)
Adjusted common equity/managed assets	24.4	28.6	32.4	33.5	39.8

Funding and liquidity: Weakened ability to maintain adequate funding and liquidity in times of market stress

In our view, Capital Securities' ability to maintain adequate funding and liquidity in times of market stress has weakened. Capital Securities has been actively building its bond trading portfolio from 2015 through to the first quarter of 2017 in line with its business strategy to diversify revenue sources. The growth came mainly from investment grade, overseas bonds of reasonably good credit quality, with an average global scale rating of 'A' from S&P Global Ratings. Much of these exposures are financial debentures, largely senior bonds, with good geographic diversification. The company's exposures to overseas bonds have grown by more than 140% in the short period of time from 2016 to the first quarter of 2017.

Like its peers, Capital Securities has been funding these bond exposures through short-term debts and repurchase agreements, which we consider as less-stable funding. The bonds on hand generally have tenors of three to five years, while funding available is of short-term, exposing the company to mismatches and potential funding and liquidity risks under stressed conditions. This is despite the fact that Capital Securities maintains a stable relationship with financial institutions in Taiwan, and the counterparties for its repurchase agreements are largely financial institutions of investment grade ratings. We also view the company's currency mismatch risk as manageable, given Capital Securities funds its overseas bond investments through USD financing and repurchase agreements of the same currency, and hedging the remaining exposures by foreign exchange swaps.

Table 6 | [Download Table](#)

Capital Securities Co. Ltd. Funding and Liquidity					
	--Year-ended Dec. 31--				
(%)	2016	2015	2014	2013	2012
Gross stable funding ratio	98.1	120.7	149.4	151.0	191.8
Short-term wholesale funding/adjusted assets	37.5	28.3	23.7	23.4	18.4
Liquidity coverage metric	87.8	105.7	107.2	107.3	164.0
Customer deposits/adjusted assets	4.4	6.6	8.8	9.6	12.6
Brokerage customer payables/adjusted assets	4.0	5.1	8.4	11.5	3.6

Related Criteria And Research

Related Criteria

- General Criteria: Group Rating Methodology - November 19, 2013
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings - April 7, 2017
- Understanding Taiwan Ratings' Rating Definitions, www.taiwanratings.com - November 18, 2014
- Criteria - Financial Institutions - General: Nonbank Financial Institutions Rating Methodology - December 9, 2014
- Criteria - Financial Institutions - Banks: Revised Market Risk Charges For Banks In Our Risk-Adjusted Capital Framework - June 22, 2012
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions - November 9, 2011
- Criteria - Financial Institutions - Banks: Bank Capital Methodology And Assumptions - December 6, 2010
- General Criteria: S&P Global Ratings' National And Regional Scale Mapping Tables - June 1, 2016
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- General Criteria: National And Regional Scale Credit Ratings - September 22, 2014

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Ratings Detail

TRC Current Ratings	Issuer Credit Rating	twA/Negative/twA-1
Issuer Credit Rating History	2017/06/12	twA/Negative/twA-1
	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

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