

Capital Securities Co. Ltd.

Full Analysis

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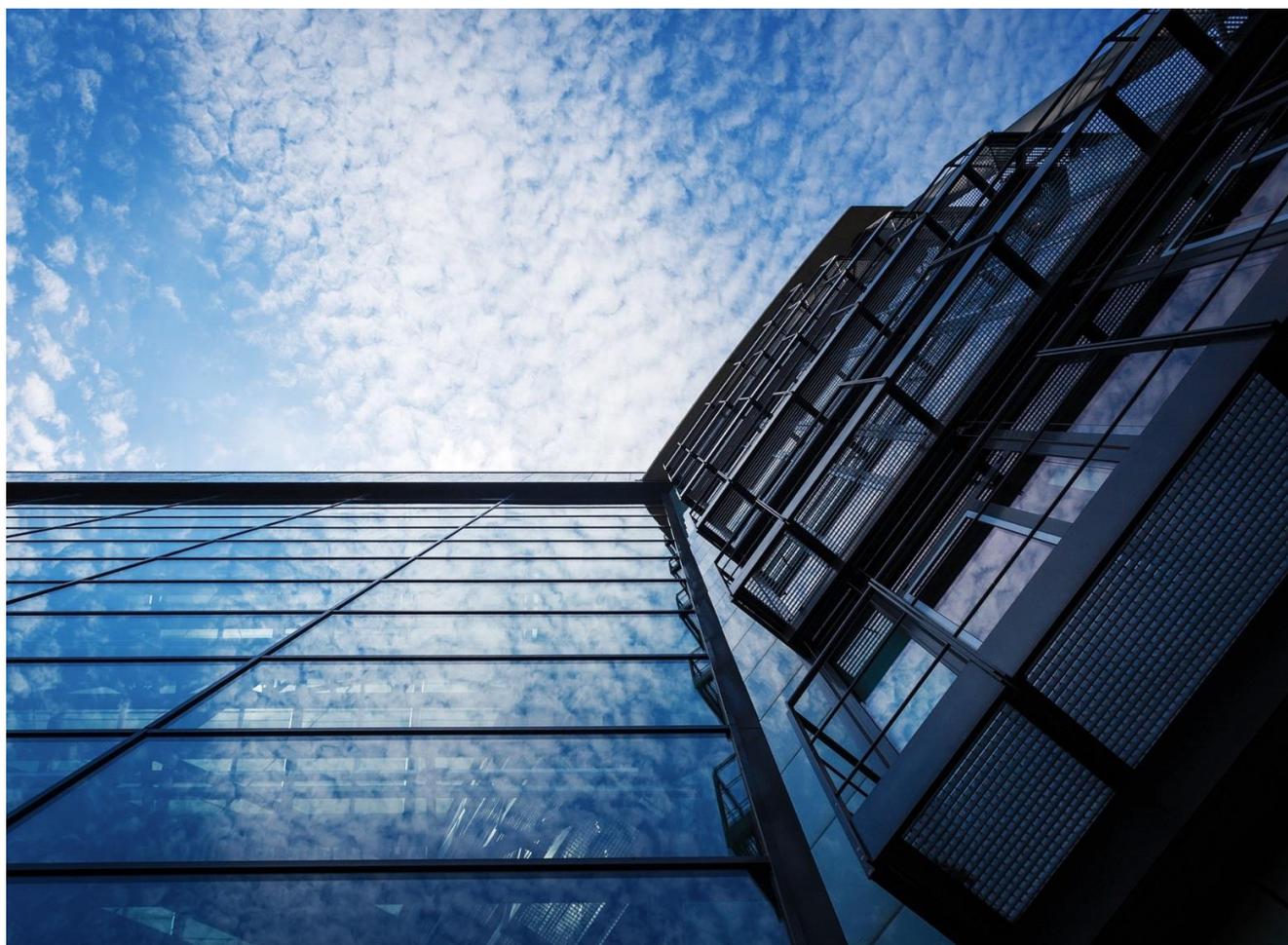
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Full Analysis: Capital Securities Co. Ltd.

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Issuer Credit Rating

twA/Negative/twA-1

Major Rating Factors

Strengths

- Very strong capitalization.
- Satisfactory market position in Taiwan's securities industry.

Weaknesses

- 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** still vulnerable ability to maintain adequate funding and liquidity in times of market stress. We expect the firm to lower its bond exposures over the next six months to one year in order to lower its potential funding and liquidity risks under stressed conditions. Despite the company's capitalization weakened amid a large increase in equity and bond holdings as of the end of 2017, we expect Capital Securities to maintain its very strong capital through the pursuit of a prudent growth strategy over the next one to two years. We also believe 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 long-term rating on Capital Securities if the firm is unable to maintain its funding risks at an adequate level or 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% or a liquidity coverage metric below 0.9x. We may also lower the rating if the company's capitalization weakens to the strong level versus its current very strong level. We measure capitalization based on our risk-adjusted capital ratio, and deterioration of the ratio to below 15% would be equivalent to a strong score. Breaching of the above triggers may result in a downgrade of more than one notch.

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, while maintaining its very strong capital level. This may occur if the company reduces its bond exposures and short-term funding, and sets a tighter limit for its tolerance on funding and liquidity measurement, increases its long-term borrowings or debts to match its 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 securities firms in Taiwan face higher economic risks than banks due to the focus of securities firms on business in the volatile domestic equity market. We also regard industry risk for Taiwan securities firms as higher than that for banks, given the less-stable revenue base of securities companies that tends to fluctuate with domestic stock market performance. In addition, the reliance of Taiwan securities firms 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+' and is two notches below the Taiwan bank anchor.

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Capital Securities Co. Ltd. Key Financial Data (Year ended Dec. 31)

(MIL. NT\$)	2017	2016	2015	2014	2013
Adjusted assets	137,899	104,457	89,725	80,121	74,366
Adjusted common equity	29,092	26,401	26,712	27,119	26,144
Total Adjusted Capital	29,092	26,401	26,712	27,119	26,144
Operating revenues	8,712	6,299	6,835	7,158	6,357
Noninterest expenses	5,070	4,620	4,801	4,725	4,563
Net income	3,215	1,406	1,728	2,144	1,573
Core earnings	3,215	1,406	1,728	2,144	1,573

NT\$--New Taiwan dollar. Copyright © by Taiwan Ratings Corp. All rights reserved.

Business position: Satisfactory market position with stable business mix

In our view, Capital Securities' stable business mix and revenues, as well as satisfactory market position in major product lines underpin the company's adequate business position in Taiwan. Capital Securities ranks fifth in the domestic brokerage business with a market share of 4.4% as of the end of 2017. This enables the company to secure good business flow in margin-lending business. Capital Securities 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. Traditional brokerage business dominates the company's stable business mix and contributes the majority of its 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 the company's performance to remain highly sensitive to Taiwan's volatile stock market over the next two years. The majority of Capital Securities' business and revenue sources remain concentrated in the local market, given the large revenue contribution from stock brokerage. However, the company has made efforts to develop new businesses, including wealth management, bond trading, and expansion overseas.

Table 2 | [Download](#)

Capital Securities Co. Ltd. Business Position (Year ended Dec. 31)

(%)	2017	2016	2015	2014	2013
Net interest income/operating revenues	16.0	18.7	17.9	17.7	17.1
Fee income/operating revenues	50.9	58.6	57.1	55.0	56.4
Market-sensitive income/operating revenues	18.8	7.0	11.3	12.5	11.1
Pretax profit/operating revenues	40.2	26.5	29.8	34.0	28.2
Core earnings/average adjusted common equity	11.6	5.3	6.4	8.0	6.0

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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 and earnings retained over the next two years. As of the end of 2017, the company's risk-adjusted capital ratio weakened, closing in on our lower threshold for very strong capitalization. The deterioration was mainly due to the increased holding of bonds and equities for trading purposes because of the good market conditions during the year. We believe Capital Securities' position has reached a high point and will somewhat reduce in the upcoming year.

The quality of the company's capital remains good, in our view, because it is comprised entirely of shareholders' equities. The firm's earnings are adequate by local standards, but somewhat volatile compared with 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, Capital Securities' capital provides a good buffer to absorb losses, in our view.

Table 3 | [Download](#)

Capital Securities Co. Ltd. Capital (Year ended Dec. 31)

(%)	2017	2016	2015	2014	2013
Leverage Ratio (IFRS)	21.1	25.3	29.8	34.0	35.2
S&P Global Ratings' risk-adjusted capital ratio before diversification	N/A	21.8	23.1	23.3	N.M.
Adjusted total equity/adjusted assets	21.2	25.1	29.6	33.7	35.1
Adjusted common equity/total adjusted capital	100.0	100.0	100.0	100.0	100.0

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Table 4 | [Download](#)

Capital Securities Co. Ltd. Earnings (Year ended Dec. 31)

(%)	2017	2016	2015	2014	2013
Personnel expenses/operating revenues	30.8	38.4	36.1	36.2	40.5
Cost-income ratio	58.2	73.3	70.2	66.0	71.8
Core earnings/operating revenues	36.9	22.3	25.3	29.9	24.8
Internal capital generation/prior year's equity	10.5	2.3	1.8	2.5	1.7
Net interest income/average earning assets	2.4	2.8	4.0	5.3	5.5

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Risk position: Adequate risk appetite and risk control

We assess Capital Securities' risk management framework to be adequate for the company's credit and market risks. Credit risk on margin lending is well controlled, given the firm's nonperforming loans ratio is insignificant and the firm has 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. Capital Securities' risk taking still tends to fluctuate according to the local stock market performance, which is similar to that of its peers. The company does not have major risk concentration and its operation remains somewhat simplistic.

Table 5 | [Download](#)

Capital Securities Co. Ltd. Risk Position (Year ended Dec. 31)

(%)	2017	2016	2015	2014	2013
Annualized adjusted assets growth rate	32.0	16.4	12.0	7.7	20.8
Adjusted common equity/managed assets	20.6	24.4	28.6	32.4	33.5

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Funding and liquidity: Ability to maintain adequate funding and liquidity remains vulnerable in times of market stress

In our view, Capital Securities' ability to maintain adequate funding and liquidity in times of market stress remains vulnerable. The company's stable funding ratio and liquidity coverage have continued to weaken and are close to the lower threshold of our adequate assessment at the end of 2017 and in the first quarter of 2018. That's due to the firm's growth in bond holdings and margin lending funded by repurchase agreements and short-term borrowings. Going forward, we expect Capital Securities to lower its bond holdings and reduce its related funding via repurchase agreements. We also expect the company's funding and liquidity to remain adequate in the coming one to two years.

Capital Securities has been actively building its bond-trading portfolio from 2015 to the end of 2017, which is in line with its business strategy to diversify revenue sources. Growth came mainly from investment grade rated overseas bonds with an average global scale rating of 'A' assigned by S&P Global Ratings. Much of these exposures are financial debentures--mostly senior bonds with good geographic diversification. The company's exposures to overseas bonds has grown by about 300% over the past two to three years. Given the good credit quality and diversity of the bond portfolio, we apply a 40% haircut on these bonds versus the 50% stated in our criteria when calculating funding and liquidity ratios.

Like its peers, Capital Securities has been funding its bond exposures as well as growing margin lending in 2017 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 available funding is of short-term, which exposes 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 with investment grade ratings. We also view Capital Securities currency mismatch risk as manageable, given the company funds its overseas bond investments through USD-denominated financing and repurchase agreements of the same currency, while hedging the remaining exposures using foreign exchange swaps.

Table 6 | [Download](#)

Capital Securities Co. Ltd. Funding and Liquidity (Year ended Dec. 31)

(%)	2017	2016	2015	2014	2013
Gross stable funding ratio*	98.1	110.7	120.7	149.4	151.0
Short-term wholesale funding/adjusted assets	42.2	37.5	28.3	23.7	23.4
Liquidity coverage metric*	94.1	97.6	105.7	107.2	107.3
Customer deposits/adjusted assets	4.3	4.4	6.6	8.8	9.6
Brokerage customer payables/adjusted assets	4.9	4.0	5.1	8.4	11.5

*We apply a 40% haircut on bond holding versus the 50% stated in our criteria when calculating 2016-2017 gross stable funding ratio and liquidity coverage metric. Copyright © by Taiwan Ratings Corp. All rights reserved.

Related Criteria

- Criteria - Financial Institutions - General: Risk-Adjusted Capital Framework Methodology - July 20, 2017
- Understanding Taiwan Ratings' Rating Definitions, www.taiwanratings.com - November 18, 2014
- Criteria - Financial Institutions - General: Nonbank Financial Institutions Rating Methodology - December 09, 2014
- Criteria - Financial Institutions - Banks: Banking Industry Country Risk Assessment Methodology And Assumptions - November 09, 2011
- General Criteria: Methodology For Linking Long-Term And Short-Term Ratings - April 07, 2017
- General Criteria: Use Of CreditWatch And Outlooks - September 14, 2009
- General Criteria: Group Rating Methodology - November 19, 2013

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Ratings Detail (As of June 20, 2018)

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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