Securities Industry in Rating Perspective

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Industry Overview

The outlook for the securities industry is stable. PEFINDO is of the view that the industry has a moderate to high risk due to its concentrated nature in many aspects, including but not limited to instrument mix, composition of income components, and selection of active stocks. The industry is also fragmented with only a few companies dominating the industry in terms of trading values and business activities. Aside from technical reasons, we also attribute the risk to the industry's tendency to highly correlate with ungovernable external factors, ranging from domestic economic conditions to dynamics in global financial markets.

Securities companies typically have a large portion of their income coming from stock trading activities. As of November 2017 YTD, stocks have changed hands 67 million times compared to only 210,000 times for bonds, given the higher liquidity that stocks provide. The leaning towards stocks is in line with the brokerage business of securities companies, which depend on the stability of trading activity whose sustainable frequency throughout the year can support the companies' cashflows.

Brokerage Business Drives Income

The country's securities industry is driven by the performance of its brokerage business (which includes taking buy and sell orders from asset management companies), discretionary trading, margin income and investment banking (that comprises of underwriting and advisory services). Based on our observation, around 50% of the industry's income comes from brokerage businesses, around 15%-20% each from underwriting and margin income, 4%-6% from discretionary trading, and the rest from others such as current accounts and sundry income. In our view, the composition is properly well-balanced based on the stability of the income that each line of the business provides. We regard the brokerage business to be the bread-and-butter of the securities industry, and while it cannot entirely decouple from the capital market's performance, in terms of earnings stability it provides a more stable stream of income as trading takes place every working day. The business takes the law of large numbers into effect as the typical buy and sell commission is regulated at 0.20% and 0.30% (or 0.18% and 0.28% if done online), respectively. Investment banking may offer greater margins but the business is highly exposed to cyclicality. The same applies to discretionary trading, which fluctuates severely, seesawing along with the fluctuations in the market and marked-to-market income recognition. Margin income is also fairly limited because of the strict regulation that governs margin trading.

Competition Landscape

The industry is populated by 106 securities companies, with distribution skewed towards large firms. The top 10 companies make up around 40% of the total value traded in the stock market. This is somewhat similar to other financial industries, such banking and financing, where the top 10 players dominate at least 40% (or more than 60% in case of banking). Large players have major institutional clients that can guarantee smooth income streams over time, typically in the form of asset management companies, pension funds, insurance companies and so on. Institutional clients dominate the industry's portfolio at around 65% compared to 35% for retail, even though the number of the institutional clients account for just 2.3% of the total number of customers in the industry. We view the granularity of the income contributions as positive from a ratings perspective, however we are also aware that well-reputed institutional clients with long track records of partnership can be credit positive owing to the steadiness they provide to the income profile. To enlarge their retail base, many securities companies are developing their own online platforms. However, given that so many securities companies are doing the same, it can take considerable time to gain traction.

In our view, securities companies that have large operations and market shares tend to have better resilience in economic downcycles compared to smaller ones. Smaller companies with no strong franchise power are also expected to face tougher competition, which could pressure their margins. The essence of our assessment of business aspects is to capture the ability of companies to withstand competition in growing in business volumes. Larger scale operations also increase the likelihood of a company attracting and retaining key employees. It is our understanding that key personnel often make significant difference, since a few key people can attract a large volume of business, and so retention is often vital. From the potential customers' perspective, in the financial service industry, bigger firms may also reflect level of trustworthiness.

The strength of the company's IT system also plays a more important part over time, as securities businesses typically deal with large volumes of transactions and various databases. We are of the view that an adequate IT system will only be a neutral factor to the rating, since IT has become highly ubiquitous among securities companies. Therefore, the lack of a robust IT system will have a negative effect, but a strong IT system will not be assessed in isolation and must be accompanied by other factors before having an impact on our assessment. Within Pefindo's portfolio, we notice that IT use is getting more extensive, in large part driven not only by regulation but also by the need to have an extra edge in the market. We consider that IT investment is capital intensive, which could be an entry barrier for smaller companies.

Diversity and Parent Support Add to Business Resiliency

A more diversified business means that a company will be able to provide a wider range of services to its clients and rely on more sources of income. However, this diversification comes at the expense of commiting more resources to each line of business. We also look at the correlation between the activities and segments that a company engages in. A high correlation among a company's various businesses can introduce high volatility in its income. Thus, as a securities company's business is highly volatile, a higher proportion of relatively more stable cash flows could help sustain its operations during business or economic downturns. We also regard the diversity of clientele types. Retail, high net worth individuals, and institutional clients are of different characteristics, and aside from the granularity of the business, a less granular business model can also be compensated by the stability of income from large clients. Other business components that can affect our risk assessment are the very high proportion of day trading business, high level of proprietary trading, and high dependence on a few clients.

We also scrutinize management aspects, as we are of the view that management quality and track record are the most important things in conducting a rating assessment of a securities company. Only good quality management can navigate a company through challenging periods. Parents, promoters or shareholders are also related to this management assessment. The track record of parents in terms of business growth, risk appetite, transparency, commitment, and financial support is highly regarded in our ratings. Thus, it is natural that our rating is often significantly affected by the presence of owners that have superior financial capacities and commitments to support the companies being assessed in times of need or difficulty.

Financial Examination: Liquidity, Capitalization and Profitability

Liquidity is of utmost importance, given that securities companies have to settle highly frequent transactions daily and deal with third party funds. Fortunately, the separation of client accounts from the company's has been enforced and regulated after the case of a well-known securities company in 2008, where billions of rupiah were embezzled from thousands of clients. The new regulations partly alleviated the risk of fund commingling and helped repair the reputational dent on the industry. Aside from that major case, there were other controversies caused by smaller companies, which were immediately addressed. In our view, frequent cases of suspension of securities companies due to alleged fraudulent activities may result in reduced confidence from potential customers, investors or creditors. This, in turn, would affect the risk profile of the industry and the investors' appetite to have a stake in the instruments issued by the industry. Aside from qualitative assessments, we look at a company's liquid assets to adjusted assets ratio, short and long-term debts to adjusted assets ratio, and the availability of loan facilities as our general yardsticks with regard to this aspect. In our portfolio, the liquid assets to total liabilities ratio of securities companies is typically above 100%, but this does not make the industry risk-free since there will still be counterparty risk in those liquid asset components. The industry is also noted for its limited financial flexibility given the low appetite from the banking sector, its limited uncommitted assets to be collateralized, and its limited track record in debt issuance.

The analysis of a company's capitalization profile covers the company's capital in terms of size, regulatory requirements, capital structure, and internal capital generation. We look at how much cushion a company has, considering whether it can sustain its operational activities and withstand any economic shock in times of distress. We generally gauge capitalization quantitatively by looking at adjusted net working capital. However, the ratios will not be taken in isolation and must be assessed along with other qualitative aspects. The only strict quantitative items that we look at regardless of other things are regulatory-related thresholds.

Last but not least, we are of the view that a company must be profitable to be able to serve its going concerns. We look into a company's ability to sustain its operating profit and margin during various business dynamics and economic cycles, the quality of its earnings, and rentability figures. We also analyze its cost structure, looking at the level of fixed costs and total costs in relation to less-cyclical income. In our portfolio, the corporate business typically provides lower margins but comes in higher value and can serve as the initial backbone of a company's income profile. Retail business becomes attractive once the company invests in IT system development to cope with more demanding transaction traffic.

Most of the industry's risks results from the fluctuating nature of the business given its high correlation with the capital market conditions, as well as controversial cases in the past that may result in lower confidence from potential customers, investors or creditors.

Stable outlook for PEFINDO's rated portfolio

PEFINDO has published the ratings of three securities companies, and their ratings span from $_{id}$BBB+ to $_{id}$A. The outlook for all rated securities companies is stable. We expect them to have a moderate growth in 2018, on the back of moderate to strong business profile, level of capitalization and liquidity position. Parent company's capacity, capability, and its willingness to support can also be a crucial factor to the rating. The common issues still remain on the volatility of the stock market, and the level of expense due to investments in IT and cost of key personnel retention.

Table 2: Rated securities companies

Company	Rating / Outlook	Market share in trading value	Equity (IDR bn)	Adjusted net working capital (IDR bn)	Debt/EBITDA	ROAA
PT Trimegah Sekuritas Indonesia Tbk	$_{id}$A/Stable	3.1%	681.4	324.5	3.1x	3.5%
PT NH Korindo Sekuritas Indonesia	$_{id}$A/Stable	0.9%	250.0	379.8	7.3x	2.7%
PT MNC Securities	$_{id}$BBB+/Stable	2.1%	441.3	279.3	2.3x	1.1%

Source: PEFINDO's database and published financial statements (as of September 30, 2017)

EBITDA (earnings before interest, tax, depreciation and amortization); ROAA (return on average assets).