



Financial Industry: Securities

May 19, 2007

BUY

Target Price :

Current Price :

Safety Margin :

Market Cap. :

ROE :

OP Margin:

PER :

PBR:

Div. Yield:

52wks Beta :

52wks High :

52wks Low :

Foreign Shares :

Major Shareholder :

SERT

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Part I. M&A Issue

With many small cap players such as KGI, Kyobo, CJ, SK, Hanyang, Bookook, YooHwa, Bridge, Shingheung, the securities industry has been regarded as another possible epicenter of M&A. Recently arising rumors boil down as follows. First, Capital Market Consolidation Law, which is expected to be approved in coming June, will give an impetus to market restructuring. Second, merger and acquisition is the only option the securities companies could choose to augment the size of the companies, in a sense that FSS have become very strict in allowing them to establish a new securities firm since 2001 when it gave out a license to Heung-gook. Third, there are currently 41 companies in the market, which appears to be excessive comparing with banking industry.

Nevertheless, things are not as simple as it looks like. First, most small cap players are not growing fast, but generating enough profit to go on their business. Moreover, those companies' major shareholders, who are usually founders and affiliates, are holding enough stakes to fight against hostile takeover. Second, without manifest synergy effect, it is not likely that securities firms acquire or merge with other companies. Third, the government does not have many shares of securities companies, unlike the big banks in banking industry where the government took a pivotal role to ignite the M&A by selling their stakes to large banks.

Part II. Financials of Securities Companies

Profit structure of securities company is different from that of other industries. Because securities company provides its own service related with capital market instead of selling tangible products. Most of the gains are generated from commission, trading and so on.

Below there are two different types of income statement. The left one is the general income statement which is well known and the right one is the income statement of securities companies. The income statement for general firms is easy to understand, so it was made simple below. On the other hand, income statement of securities company is

more specified.

<General Income Statement>

Items
Sales
(-)Cost of Sales
Gross Margin
(-)General and administrative expenses
Operating Income

<Income Statement of Securities Company>

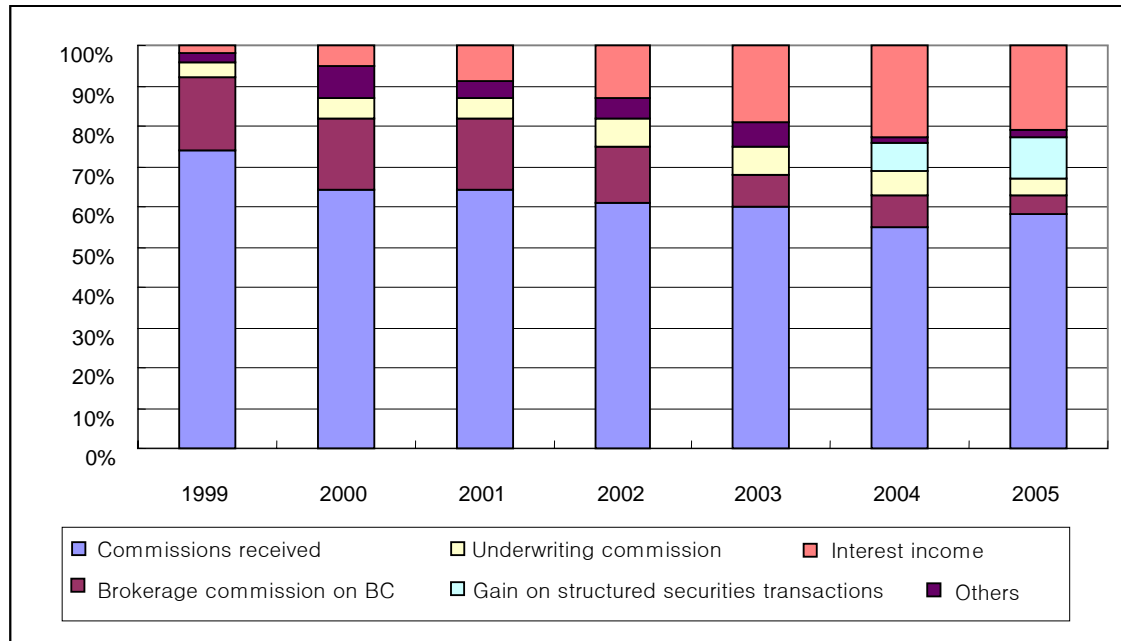
Items
Operating Income
Commissions received
Brokerage commission
Underwriting commission
Interest income
Gain on sales of trading securities
Gain on valuation of trading securities
Gain on structured securities transactions
Gain on derivatives transactions
others →
(-) Operating Expense
Expense or Loss of items at upper
General and administrative expenses
Operating Margin

Gain form others
Dividends income
Distribution income
Gain on valuation of trading securities sold
Gain on structured securities transactions
Gain on valuation of Reserve for claims of customers' deposits (trust)
CMA income
Commissions on CMA
Lease income
Gain on disposal loans
Others

The income statement for securities companies does not have an item with the term 'Sales'. Otherwise, there is the operating income item which corresponds to Sales of other general company's income statement. With the same point of view, the operating expense can correspond to cost of sales of general income statement. After operating Margin, items of both statements are the same.

Brokerage commission is the most important item of income statement. Its proportion has accounted for the biggest part of OP. Even though securities companies have diversified its revenue structure, brokerage commission is still a major source of income. Brokerage commission of four major securities companies declined to about 50% of total sales in 2006, from 74% in 1999. Beneficiary certificates margin has been expected to grow, but in 2006 it was just below 5% of total profit because the market has become a red ocean as almost all securities companies tried to engage in the market.

<Income Statement for Securities Company>



According to this chart, profit structure of securities companies depends on only total amount of trading which can not be controlled by them. Total amount of trading is influenced by market situation. The correlation between gains from beneficiary certificates and total amount of trading is definitely low and BC's sum total is also small.

Gain on structured securities transactions like ELS or ELW was expected to diversify profit, but its trading amount also goes together with market situation. In conclusion, securities companies' profit is weighed by trading volume in the market but other causes are not critical.

Part III. Business Model

1. Brokerage Commission

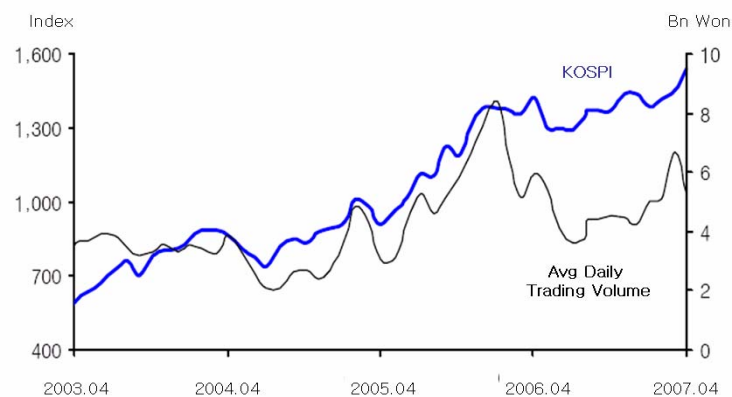
Domestic securities companies' business model is mainly focused on brokerage commission. Securities companies earn brokerage commission when the company gets orders from investors and complete each transaction. Brokerage commission is dependent on trading volume and commission fee in each transaction.



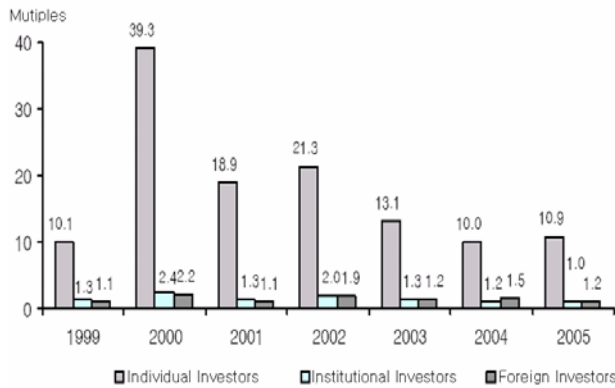
► Increasing Trading Volume but declining turnover rate

Korean Stock Exchange set new records by reaching 1600 recently with constant capital inflow mainly led by retail investors. The increase in trading volume indicates higher revenue from brokerage commission. In addition, market capitalization will increase with the Initial Public Offering of life insurance companies, KRX and Samsung card. As the new entrants will trigger more transactions in stock market, increasing market cap will be beneficial to securities companies.

[KOSPI and Average Daily Trading volume]



On the contrary, turnover rate, which denotes how often stocks are traded in a certain period, is declining. This is not only because the absolute trading frequency has decreased over years, but also institutional and foreign investors account for larger proportion in trading.

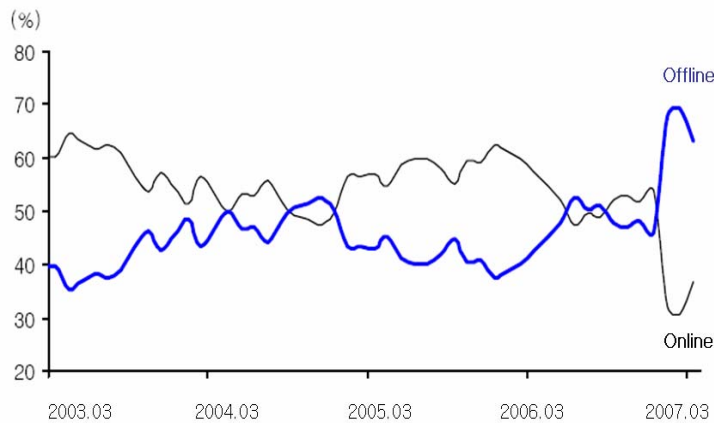


$$\text{Turnover rate} = \frac{(\text{Trading Volume})}{(\text{Total No. of Stocks})}$$

► Commission Fee is expected to decrease due to severe competition

Different channels have different commission fee system, where online commission fee (0.5%) is much lower than offline in average (4~5%). Proportion of Online transaction has increased due to the lower commission fee and higher accessibility, which can undermine profitability. Moreover, securities companies are competitively lowering commission fee to expand customer base and increase market share.

[Trend in Online and Offline Transactions]



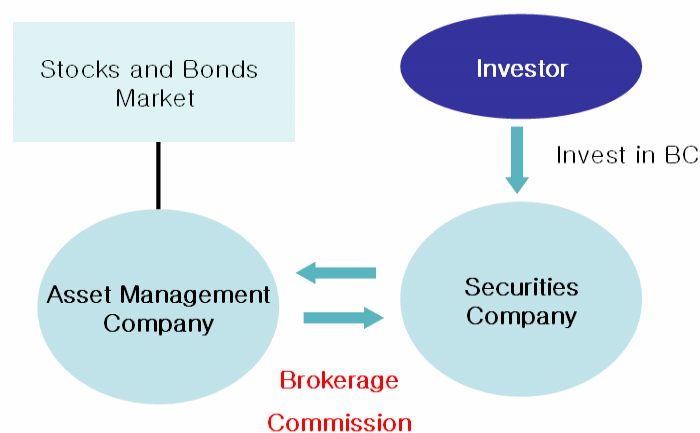
► Steady cashcow, but should be less focused

Brokerage commission has worked as a steady cash cow and securities companies could even cover the whole sales, general and administrative expenses with it. It is well known that securities companies can sustain for another 3 years with the gains from brokerage commission earned in bullish market for one year.

However, dependence on brokerage commission can make securities companies vulnerable to exogenous factors. As stock market situation determines brokerage commission, it will be risky to rely on unpredictable source of income. Therefore, securities companies are in the move to diversify business model to be less dependent on brokerage commission.

2. Brokerage Commission on Beneficiary Certificate

Beneficiary Certificate is issued to guarantee investors' right to receive principal and interest gains from financial products when investors trust their money to investment trust companies. It is different from mutual fund in that mutual funds are not just financial products, but paper companies where investors become stakeholders. Almost 95% of funds currently traded are beneficiary certificates. Investors are 'buying' BC when they are investing in financial products. As securities companies work as channels to sell BC to investors, they receive brokerage commission from investment trust companies.



3. Underwriting Commission

Securities companies charge underwriting commission when they offer agency services when client companies are listed on the stock market or issuing corporate bonds. As 80% of securities companies are authorized to undertake underwriting, it has long been regarded as an ordinary transaction, which is even possible without expertise. Therefore, domestic players have triggered fierce competition in underwriting activities, which led to

lower commission fee (3%) and deteriorating service quality,

4. Structured Securities

Since 2004, securities firms have engaged in business providing customers with structured securities such as ELS(Equity Linked Securities) and ELW(Equity Linked Warrants). Being exposed to high risks involved in these new types of investment vehicles, securities houses hedge their risks by either back-to-back transactions with large foreign investment banks or trading bonds and futures themselves. Hence, profit relies on upon the difference between total value of issuances they offered to investors, whether they are institutions or individuals, and cost that arises when hedging.

▶ Who are entitled to sell structured securities

Not all securities companies are allowed to sell structured products. Currently, thirteen players are in the market including Samsung, Daewoo, Woori, Goodmorning Shinhan, Hana, Hyundai, Daishin, Mirae, Macquarie, Kyobo, and Meritz, and a few other securities are preparing for attaining OTC license. That is, it is certain that this market is going into fierce competition, shrinking the margin. Margin is normally 1% of nominal amount of products sold using back-to-back method, and 2-3% hedging themselves. Notwithstanding, securities firms are expected to enhancing their capability in OTC business, in accordance with rapid market growth.

▶ How it appears on financial statements

Performance of business related to structured securities could be found by several items in financial statements. Key items on income statements are (1) *Sales commissions on structured securities*, which is the premium received when issuing, (2) *Gain/Loss on transactions of structured securities sold*, which is the profit or loss that arises in periodical evaluation and early redemption of issued ELS and ELW, and (3) *Gain/Loss on structured securities transactions*, which can be used to figure out the cost of hedging. On balance sheets, *structured securities* indicate the value of the hedging provided by investment banks, whereas *structured securities sold* refer to the value of issued ELS and ELW in total.

5. Principal Investment

In line with the efforts of securities firms to become investment banks, several large firms began to turn eyes on PI(Principal Investment). This endeavor is expected to come into effect from this year. What is crucial in PI is the number of bullets, i.e. size of shareholders' equity. Minimum level of equity seems to be KRW 1 trillion, which means only five or six companies are able to execute profitable investment plan.

Company	Equity	PI confirmed	PI expected	Strategy
Daewoo	1.9	0.5	0.2	Exploration, Equity, Real Estate PF, M&A
Woori	2.1	1.1	0.3	PEF, Acquisition of unlisted shrs, Foreign direct investment
Samsung	1.9	-	0.2	TBD
Hyundai	1.5	0.3	0.2	Real Estate PF, M&A, SOC
Daishin	1.5	-	0.2	Index, AI

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