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Credit risk of Coinbase surges as the "crypto winter" contagion makes landfall

by Elaine Uy

- **NUS-CRI 1-year Probability of Default for Coinbase skyrockets as dramatic drops in cryptocurrency prices and surging inflation depress revenues**
- **Increasing regulatory scrutiny might potentially impair investor confidence in Coinbase's operations, contributing to a decrease in market value**

After the impressive rally in 2021, the cryptocurrency market is experiencing a massive reversal exacerbated by the de-pegging of the TerraUSD stablecoin in May-2022 which sent jitters among investors. The subsequent withdrawal of capital from the crypto market created widespread liquidity concerns and contagion effects leading to the collapse of crypto heavyweights Celsius Network, Three Arrows Capital and Voyager Digital Ltd. These failures stoked market fears about the future of the crypto market such that even the largest cryptocurrency exchange in the US, Coinbase Global Inc. saw a contraction in its revenues. The recent volatility that has dissuaded investors threatens the company's top line[1], and vis-à-vis, its credit profile, causing an increase in its NUS-CRI 1-year Probability of Default (PD) (See Figure 1a). Aside from decreasing revenues, the increasing regulatory scrutiny could translate to additional costs further squeezing its strained margins and diminishing liquidity. As the bearish market conditions continue, Coinbase's profitability woes could persist in the short-term resulting in a prolonged deterioration in its credit health as suggested by the NUS-CRI 1-year Forward[2] PD (See Figure 1b).

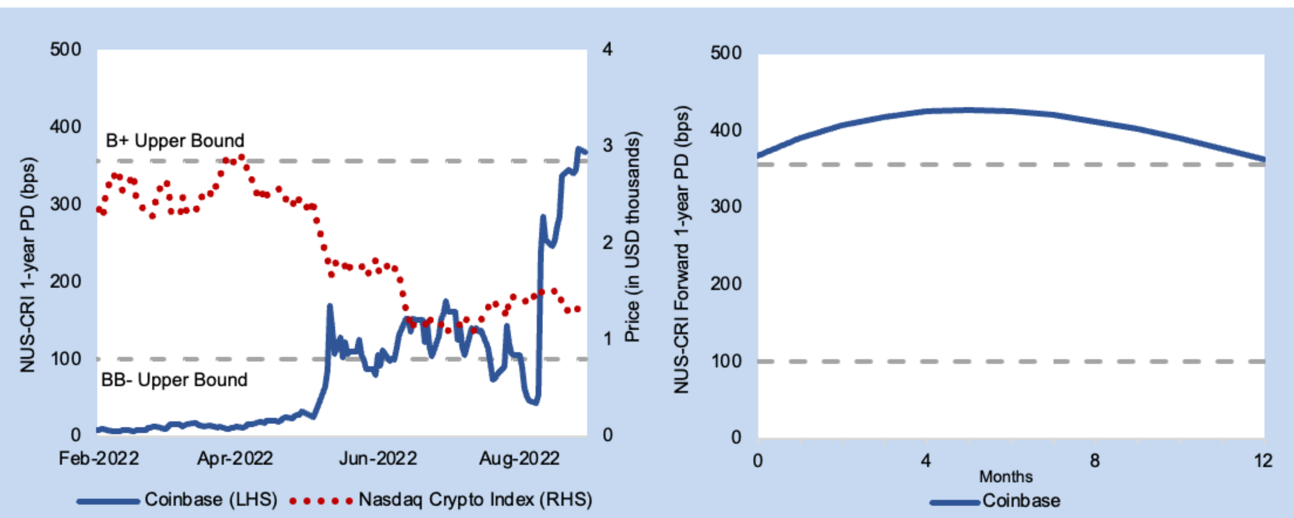

Figure 1a (LHS): NUS-CRI 1-year PD for Coinbase, with reference to PDiR2.0 bounds[3]; Daily closing values of the Nasdaq Crypto Index (NCI) from Feb-2022 to Aug-2022. Figure 1b (RHS): NUS-CRI Forward 1-year PD of Coinbase as of Aug-2022, with reference to PDiR2.0 bounds. *Source: NUS-CRI, Refinitiv*

With the US economy still battling with surging inflation, the crypto industry has not had the chance to recover. Possibly owing to the steep drop in crypto prices (See Figure 1a), cryptocurrencies' designation as a potential inflation hedge may have been debunked. Recently, movements in the crypto prices have synced with other more traditional assets such as equities, indicative of increasing correlation and suggestive of the responsiveness of cryptocurrencies to the macroeconomic forces that affect the other asset classes. As the Fed continues to hike interest rates to tame inflation, investors may be pressured to sell riskier or more speculative

[1] For the period ending Jun-2022, 84.4% of revenues represent transaction fees for trades that occur on Coinbase's platform.
[2] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similarly to a forward interest rate. For example, the 6-month Forward 1-year PD is the probability that the firm defaults during the period from 6 months onwards to 18 months – this is conditional on the firm's survival in the next 6 months.
[3] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation through mapping the NUS-CRI 1-year PDs to the S&P letter grades. The method targets S&P's historical credit rating migration experience exhibited by its global corporate rating pool instead of relying solely on the reported default rates.

investments in favor of guaranteed returns or cash. In Coinbase's case, for instance, trading volumes[4] as of Jun-2022 had tallied 34% lower compared to the same period in 2021, with those pertaining to retail transactions shrinking by close to 55% (See Figure 2a). On the positive side, the partnership between Coinbase and BlackRock, could potentially boost institutional trading volumes, compensating for the loss in retail investors activity. With a potential increase in the revenue stemming from an uptick in institutional trades, Coinbase's profitability concerns may be buffered and drive the recovery of the company's credit profile, as suggested by the subsequent downward trend of the Forward PD (See Figure 1b).

The impact of the "crypto winter[5]" on Coinbase has been reflected in the dive in its stock price which has wiped out 80% of its market capitalization since Dec-2021, indicative of the company's deteriorating financial performance. Operations for Q2 2022 concluded with a 63.7% YoY decrease in revenues and a USD 1.1bn loss. Such devaluation of Coinbase's equity weakened its credit profile, increasing its debt-to-equity ratio to 58.3% as of Jun-2022 (from 53% in Dec-2021). While Coinbase's nearest maturing debts (41.82% of total debts outstanding) only become due in 2026, its hampered profitability might impede its ability to generate adequate cash flow for interest payments or support its operations and other business activities, especially with its similarly deteriorating liquidity metrics (See Figure 2b).

To augment its weak earnings, Coinbase had instituted drastic cost-cutting measures, but had, nonetheless, acknowledged the seriousness of the threat that it had included a risk disclosure on the treatment of customers' assets in the event of bankruptcy, contributing to market fears. The downbeat earnings update feeds into the market's pessimism, considering that despite Coinbase's relative size, it is also struggling to weather the "crypto winter", resulting in the further decline of major crypto prices as further contagion concerns within the market gathered steam. In the face of its deflating market share, Coinbase's revenue generation capabilities are further threatened by its peers' pricing strategies to reclaim lost demand. Aggressive competitive pricing could result in fee compression from its retail transactions (which comprise 94.83% of total transaction revenue for the period ending Jun-2022).

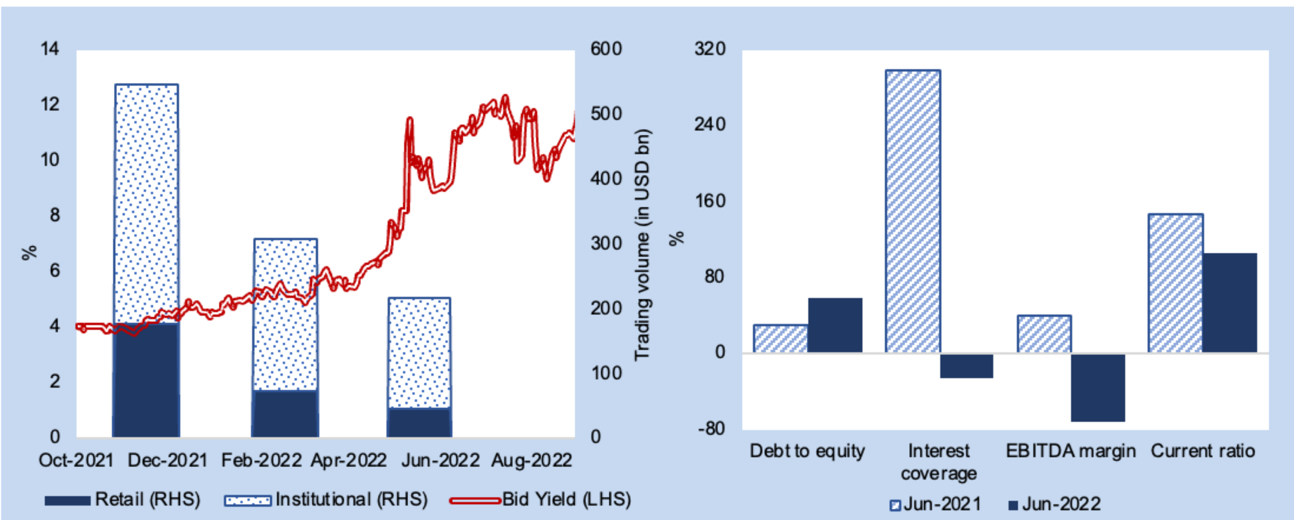

Figure 2a (LHS): Quarterly distribution of Coinbase's trading volumes among retail and institutional transactions from Q4 2021 to Q2 2022; Daily bid yields of Coinbase 3.375% senior note maturing Oct-2028 from Oct-2021 to Aug-2022. Figure 2b (RHS): Selected financial ratios of Coinbase as of Jun-2021 and Jun-2022. *Source: SEC, Refinitiv*

Correspondingly, the market has priced in Coinbase's heightened risks into its debt offerings, with all outstanding bond yields jumping over 11% (See Figure 2a). Expected further increases in interest rates prompt bondholders to demand higher premia to retain their holdings in riskier assets amid signals of a worsening economic outlook, resulting in a widening spread over safer government securities. Should Coinbase require additional financing, it could be compelled to take on higher borrowing costs, which would depress its already hampered earnings and liquidity position, as the alternative would necessitate substantial dilution of existing stockholdings for the same amount of funding given the declining stock price.

Adding to the pressures faced by Coinbase, regulatory risks are also rising. The SEC had started its probe on the company's listing and trading processes, and staking programs in Jul-2022. These ongoing investigations

[4] USD equivalent value of matched trades.
[5] Crypto winter pertains to a contraction in crypto prices for a prolonged period.

could translate to additional costs, legal implications, or sanctions in case of unfavorable outcomes, adding to Coinbase's profitability concerns[6].

In the near term, Coinbase's credit health might need to endure the continuing effects of the crypto winter and bearish market conditions (See Figure 1b). However, its resilience would depend heavily on its ability to address or manage its profitability, and potentially solvency, woes. In the longer term, the high-profile bankruptcies in the crypto industry might result in a permanent loss in investor confidence in centralized crypto institutions and instead shift their inclination to decentralized finance, presenting a greater threat for Coinbase.

[6] Moreover, the increasing regulatory attention might also adversely impact the firm's reputation and stock value resulting in the reduction of its stock price.

Credit News

No escape from biggest bond loss in decades as Fed keeps hiking

Sep 4. Swap traders are leaning toward a 75bps rate hike for Sep-2022 as Fed takes on a more hawkish approach to curb inflation. Treasury yields have been faring higher than the upper bound of the Fed target rate and are expected to continue rising, suggesting a further downside potential for bond prices. The treasury market has accumulated a loss of over 10% YTD and is likely to deepen further. Similarly, the hawkish move has also affected stock markets, with S&P500 down by 17% YTD. The consumer-price index and other economic reports to be released over the next week will provide more clarity regarding Fed's interest rate decision on Sep-2021. (Bloomberg)

European debt market hit by historic sell-off after rate rise bets

Aug 31. Soon after the Aug-2022 inflation report was published, European bonds experienced a massive sell-off, during which returns on high-grade government and corporate bonds fell by 5.3% - a record high since 1999. Driven majorly by surging food and fuel prices, consumer price growth rose by 9.1% in Aug-2022, reinforcing expectations of further hawkish moves by the ECB and BoE. Major investment bankers, such as JPMorgan, Goldman Sachs, and Bank of America, are eyeing a 75bps hike in the interest rate during the Sep-2022 policy meeting, which could potentially plunge the region into a recession. (FT)

Fund managers shun China property bonds on default risks

Sep 2. Fund managers are trimming their positions in Chinese property bonds by more than 50%. The majority of dollar-denominated bonds issued by these firms are trading within the distressed territory – below 50c on the dollar. This is amid the backdrop of buyers boycotting mortgage payments, sales & prices falling and multiple less than effective attempts to provide liquidity to these developers. The market is looking out for a pick-up in pre-sales and reopening of the capital markets. (Reuters)

UK markets see worst August in years and rout may continue

Aug 31. GBP reported the biggest monthly fall since the Brexit vote fallout. Gilts and corporate bonds were also heavily sold as credit spreads spiked. This is amid a fatal mix of twin deficits, double-digit inflation increased issuance, and a pending recession. Institutional money is leaving UK assets as investors struggle to believe that the Bank of England will raise interest rates quickly. The market believes that a dragged-out energy crisis will push the UK economy into a recession. (Bloomberg)

Investors flee from junk bond funds amid USD 5bn outflow

Sep 2. As Federal Reserve Chair Jerome Powell refused to waver from his commitment to hike interest rates, US high-yield bond funds experienced their second highest weekly outflow of USD 5bn as investors exited risky assets. At the same time, US investment-grade bond funds also experienced outflows of USD 4.6bn. Concurrently, spreads on riskier bonds widened considerably, with spreads on CCC debt widening to the level of distressed debt spreads. Investors are increasingly skeptical of corporates' ability to service obligations amidst the higher interest rate environment and recessionary headwinds. (Bloomberg)

Evergrande bondholders push their own plan for debt revamp (FT)

Credit markets are way underpricing recession risk, UBS says (Bloomberg)

Bank CFOs weigh in as corporate loans face test in Canada (Bloomberg)

Regulatory Updates

ECB makes hawkish shift as inflation surge shreds faith in models

Sep 5. ECB is taking up a more hawkish approach as inflation soars to unprecedented levels, challenging the ECB's models of temporary inflation. Inflation has constantly been on the rise for nearly a year, largely driven by rising energy prices and the weakening of the euro. The market now expects a 75bps rate hike in the Sep-2022 policy meeting, in line with Isabel Schnabel's speech at the Jackson Hole meeting. While the anticipated interest rate hike would possibly raise unemployment rates and create recessionary pressures, the ECB governing council is also looking to limit the larger revenue the banks could generate due to larger borrowing costs. (FT)

China to require approvals for firms to issue offshore debt

Aug 30. As offshore debt defaults mount up to historical highs of USD 37.3bn, China tightens its regulations regarding the approval and usage of offshore debt. The new guideline necessitates Chinese firms to register, report and receive approval from China's National Development and Reform Commission (NDRC) to issue foreign debt and are required to follow up with information regarding the use of proceeds and repayment abilities. The regulation tightening is aimed to engender sustainable debt financing practices, as well as appeal to foreign investors who had recoiled from Chinese markets due to the mounting defaults and US dollars strengthening. (Bloomberg)

Japan raises assumed interest rate for FY2023/24 debt servicing (Reuters)

Australia set for fourth half-point hike in race to cool prices (Bloomberg)

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