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Cox & Kings, India's leading tour operator, faces heightened credit risk

By Vishal Kumar Singh

Cox & Kings Limited, set up in 1758, is one of the longest established travel companies. Having spread its operations across 23 countries and 4 continents in the past 260 years of its existence, it is a premium brand in all travel related services in the Indian subcontinent. But over the past decade the company has ambitiously pursued an incoherent business growth strategy, notably in overseas markets, which pushed up the debt while undermining the earnings and the stock valuations. One of the issues is the company's worsening financial performances in the wake of several acquisitions done over the last few years. An example of this is the acquisition of the UK-based company Holiday-break, which had higher revenues than Cox & Kings, in August 2011. The company then sold Holiday-break's camping division in 2014 and the education business in 2018 in order to use the sale proceeds to reduce its debt and maximize the shareholder's value.

The NUS-CRI 1-year Probability of Default (PD) for the company was significantly high at 360 bps in the year 2016 when it had to face the heat of demonetisation. The effect of demonetisation was more intense in the travel sector due to negative effect on disposable income and unavailability of money even for the basic needs. With the withdrawal of the old currency notes and the resultant liquidity squeeze, investors were plagued with worries about tightening discretionary spending. However, the company's major decision of demerging its forex business, with a plan to list it as a Non-Banking Financial Company for holiday financing and student loans, saw its balance sheet improve greatly and helped it flourish after that. As illustrated in Figure 1, the PD for the company went on rising after they sold off their education business to maximize the value of hotels vertical until it reached around 400 bps before defaulting on commercial papers. At the same time, the Aggregate 1-year PD of all the travel services companies across the globe remain below 100 bps as most of the companies in this sector have diversified their risk by expanding into other sectors. The Aggregate PD refers to the average of the PD of all the companies in the travel services industry globally.

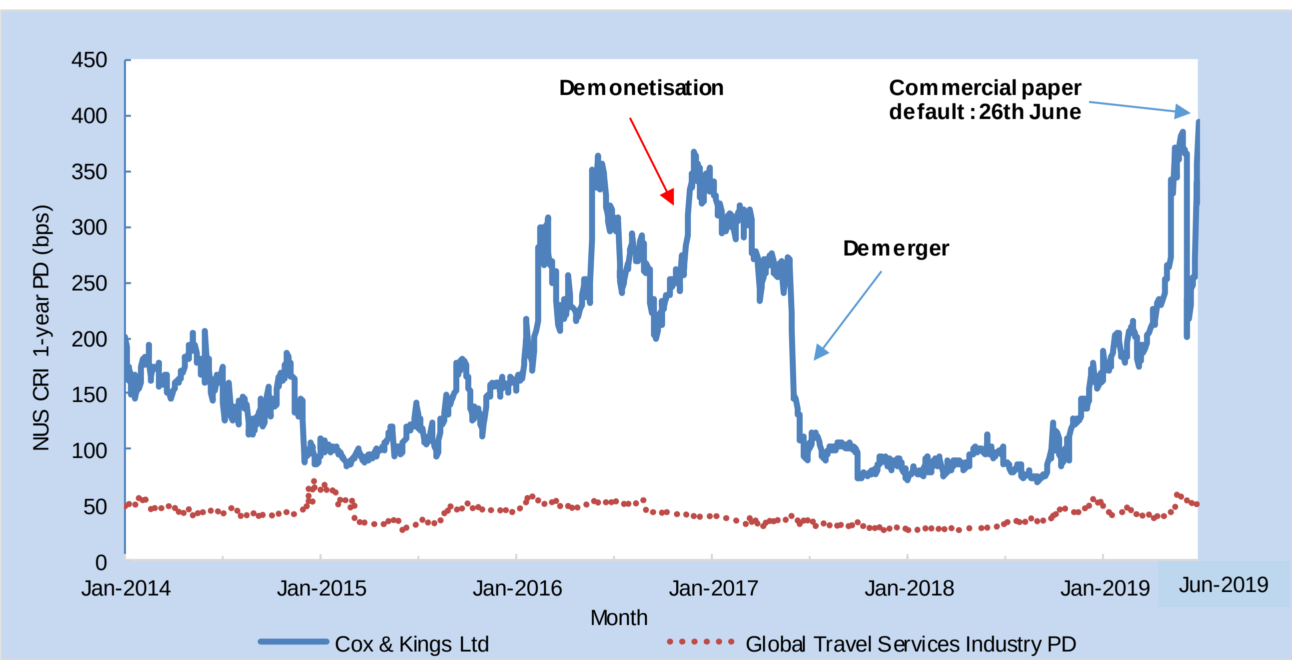

Figure 1: NUS-CRI 1-year PD for Cox & Kings Ltd in comparison with the Global Travel Services Industry PD. *Source: NUS-CRI*

The company failed to meet multiple debt payment obligations towards maturity of unsecured commercial papers in the past couple of weeks, which led to a stock loss of 71% in the past one month. This resulted in the down grade of credit ratings of this company's instruments by CARE Ratings from CARE AA to CARE D within a month. This has also led to the drop of shares of Tourism Finance Corporation of India, an All-India Financial Institution for providing financial assistance for tourism, by 24% within 2 days of the default, hitting an over two-year low after concerns surfaced over the company's substantial exposure of lending money to Cox & Kings. The rating is also constrained on account of continued high levels of pledged shares by the promoters and low market capitalization, which has decreased by 80% as compared four years ago.

	FY2014	FY2015	FY2016	FY2017	FY2018
Total Debt / Equity (%)	67.49	21.75	48.68	44.92	66.06
Receivables Turnover ratio (X)	3.17	5.8	4.45	3.16	2.44
Free cash flow (INR mn)	366.7	1942.1	-1236.1	-12371.3	-
Free cash flow to Firm (INR mn)	1505.2	1799.9	-14.2	-11017.8	-
Net Income (INR mn)	1126.9	1411.7	1653.8	1813.4	1760.5

Table 1: Financial Analysis of Cox & Kings Ltd. *Source: Bloomberg*

Table 1 shows that the free cash flow of the company has been worsening in the last few years, entering the negative zone in 2016. This suggests some issues with its profitability as the free cash flow to firm, which is essentially a measurement of a company's profitability after all expenses and reinvestments, was at a record negative. At the same time, its total debt to equity ratio at the end of the financial year 2018 was 66.06%, much higher than the global industry median of 20.56% signifying the huge amount of debts the company has. The account receivables turnover ratio, an activity ratio showing a company's ability to manage the credit, has dropped to 2.44 against the global industry data of 12.56 for the same. The poor management of its receivables becomes a bigger concern at the occurrence of a credit event.

The already concerning working capital situation with increasing current liabilities at Cox & Kings was stretched even further in the last few months due to its inability to replace the short term loans with the long term loans (Figure 2a). Reportedly around 37% of its subsidiaries are making losses. In the past five years ending FY2018, loans and advances to subsidiaries have jumped by more than 200%, from INR 4.7bn in FY2014 to INR 14.6bn in FY 2018 while the investments in overseas subsidiaries have raised by 92%.

The company is borrowing short term loans and investing in overseas subsidiaries as equity and as a result, the dependence on its standalone operations has become very high. It must generate enough revenues to service the interest on short term loans as its investments in overseas subsidiaries as equity would take long to yield adequate returns. Another worrying factor for the market and investors is that this company has a huge amount of outstanding bond principal, interest and non-fixed income debt maturing, especially in this year, as compared to the magnitude of the firm's net income over the past years. (Figure 2b). The company needs to carve out plans to pay the amount for the instruments' maturing in 2019 so that it can sustain in the upcoming years. The company further plans to meet its financial obligations through a combination of internal accruals and monetization of assets.

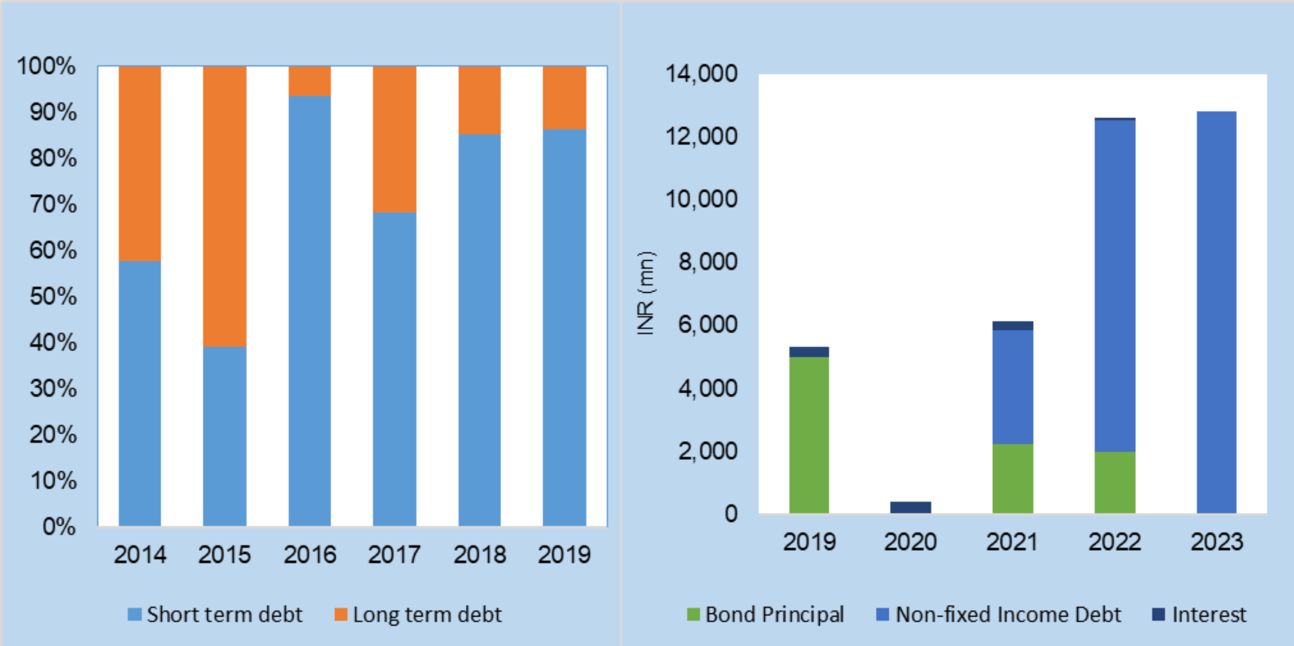

Figure 2a & 2b: Increasing percentage of short term debt over long debt in the past years and the total amount of instruments maturing in near future. *Source: Bloomberg*

Cox & Kings has claimed that the defaults occurred due to cash flow mismatch and a situation exacerbated by the rating downgrade. The promoters of the companies are willing to divest majority stakes in some of the units or could sell one or more of their products to raise capital. The brand name of the company and its widespread network across the country can help it to revive. The company is also working closely with its lenders to optimize its strong asset base globally and bring the situation back to normal.

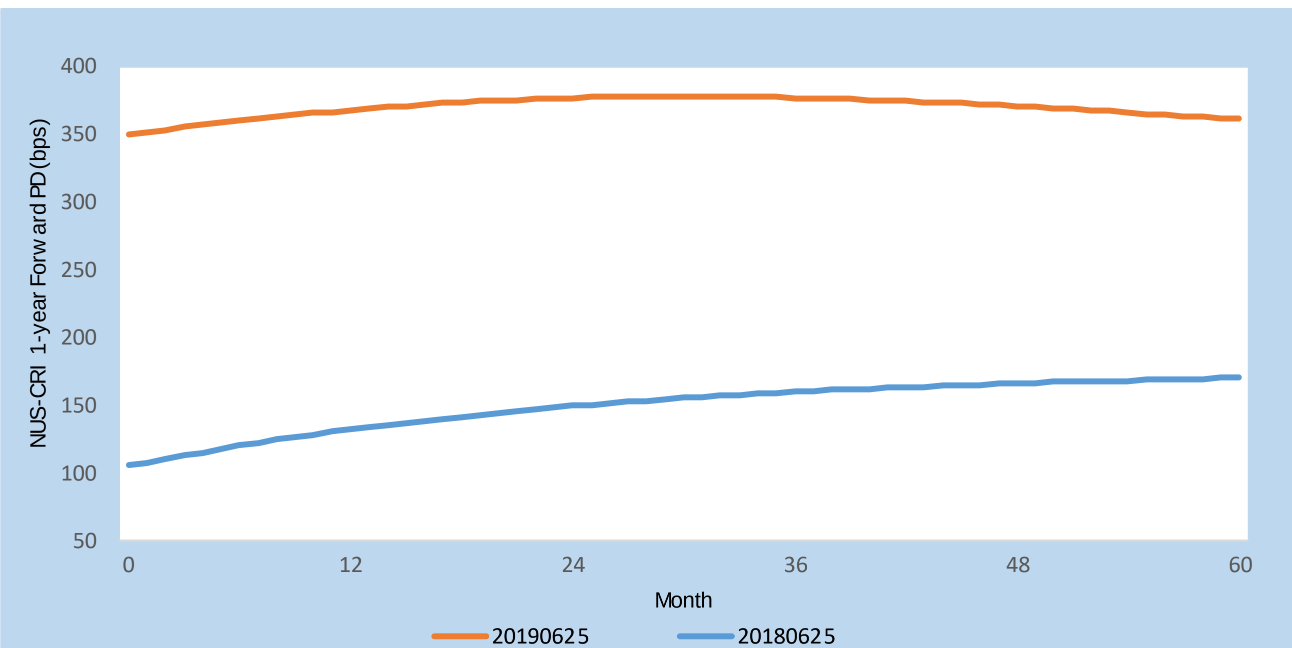

Figure 3: NUS-CRI Forward 1-year PD term structure for Cox & Kings Ltd as of July 2018 and July 2019. *Source: NUS-CRI*

The NUS-CRI Forward 1-year PD term structure has changed drastically in magnitude over the past year as seen in Figure 3. The Forward PD calculates the conditional credit risk a company faces in its future. The Forward PD works similarly to a forward interest rate. For instance, the 3-month Forward 1-year PD is the probability that the firm defaults during the period from 3 months onwards to 1 year plus 3 months, conditional on the firm surviving the next 3 months. The increase in the magnitude of the PD signifies the worsened credit risk the company faces on comparing the two different time periods. The gap between these two remains almost equal illustrating that the risk faced is long-term in nature. The riskiness of the company however does not decrease in the near future as indicated by the more recent data, remaining at a roughly equal level.

Credit News

How ‘Transition Bonds’ Can Help Polluters Turn Green

Jul 14. A new class of bonds, transition bonds, is gaining traction and could greatly expand the green credit market. Unlike the conventional green bonds restricted to financing projects that are environmentally friendly, transition bonds focus more on the issuer’s behavior and commitment to switch to a cleaner way of doing business. Non-green companies such as oil producers and coal miners would have the chance to issue transition bonds. However, risks remain and investors maintain their wary and skeptical stance. Transition bonds could provide cover for companies not fully committed to shifting away from their carbon-intensive activities. Yet if firms can seek financing based on environmental goals and more investors shift towards the asset class, transition bonds could see growth similar to that of sustainability-linked loans. (Bloomberg)

China's corporate bond defaults tripled to USD 8.7bn in first half

Jul 13. Chinese corporate bonds are on track to hit record highs this year. Beijing reversed its policy of cutting debt in the second half of 2018 as the trade dispute with the US escalated but analysts observed that companies were already in financial difficulty due to unregulated expansion policies and an economic slowdown. Defaults on corporate bonds nearly tripled from a year earlier in the first six months of 2019, according to research company Shanghai DZH. An estimated of CNY 6tn of onshore bonds are due to either mature or become puttable this year, weighing on the second half. Chinese corporations are also expected to face a liquidity squeeze in the second half. The funding environment has worsened after Baoshang Bank was taken over by the government. Corporate debt defaults were rare in China till 2015 as local governments lent a helping hand to rescue companies that were in financial trouble. The tide changed in 2016 when President Xi’s government embarked on radical restructuring to burn off excess production capacity. The escalating trade tension between US and China has prompted the Xi administration to spur economic growth by urging banks to ramp up lending to prevent corporate bankruptcies. With this new direction, corporate defaults have not declined significantly. (Nikkei)

Sub-zero bond yields force investors out of their safety zones

Jul 11. In the prospect of monetary easing by the ECB, benchmark yields in Germany on other major euro-area debt markets hit all-time low in July. With over USD 12.tn of global debt – including benchmark bonds in Germany, France and Austria – slipping into the negative-yielding zone, banks and money managers are struggling to search for returns. Some investors are venturing beyond their safety zones into emerging markets with relatively low valuations and better yields, while some seek to cut duration on their fixed-income holdings on the view that global long-term debt rates no longer compensate buyers for the corresponding credit risk. Adding to investors’ dilemma is the fact that they also need suitably safe assets to guard against a global economic downturn. (Bloomberg)

S&P rating is landmark for Chinese bond market

Jul 11. S&P Global Inc has become the first foreign credit-rating company to offer an independent assessment of risk in China’s domestic debt market. This move is a significant step for the USD 13.3tn onshore bond market, where foreign investment is increasing and the world’s three major rating companies- S&P, Moody’s and Fitch - have long coveted a bigger presence. Global rating houses were previously required to pair with local partners in conducting credit ratings in China. Fitch and Moody’s have both set up wholly owned subsidiaries and applied for licences to rate bonds in China’s interbank market. With the influx of foreign rating companies, investors are hoping that the quality of the local rating industry would improve as it has long been deemed as overly lenient with debtors. (Bloomberg)

India’s bond market could benefit from some sin

Jul 9. While governments in emerging markets have conventionally gone with developing domestic bond markets, India’s Finance Minister announced that the country would issue foreign-currency bond. Local media reported borrowing of about USD 10bn could begin in the second half of the year. Although issuing foreign-currency debt has traditionally been seen as the “original sin” of emerging markets, analysts feel that this might be a good move for India. This is because an increasing number of India’s corporations with significant international business have been turning to the dollar bond market with lower yields. Yet corporate bonds are often priced in relation to the government yield curve; hence having sovereign dollar bonds would help Indian corporations to issue in the US market, allow investors to better price private-sector debt and aid liquidity. This reduces yields and corporate bid-ask spreads. With its current small amount of dollar-denominated debt and strong position, borrowing dollar is not likely to harm India and might help its corporations as they step out into the world. (WSJ)

Huawei to raise USD 1.5bn as it fights long-lasting sanctions (Nikkei)

Real-estate companies amass cheaper but riskier short-term debt (WSJ)

Deutsche Bank's bank capital debt back in the red, CDS decline (Reuters)

Regulatory Updates

China tightens curbs on property firms raising money offshore

Jul 12. China is tightening property developers to raise funds offshore. Any new offshore bond issues by real estate firms must be used only to refinance medium- and long-term offshore debt maturing in the next year but not to repay domestic debt, to replenish liquidity, or to acquire land. Developers are also required to hold a “reasonable position” in their foreign exchange reserves to contain foreign debt risk. More information disclosure on how they will use the funds raised offshore is also required on bond prospectus. (Reuters)

India’s war on world’s worst bad-debt pile stalled by regulators

Jul 12. India’s battle against the world’s worst bad-loan ratio is being stalled by regulators and federal investigators. The country’s authorities are faced with legal challenges such as the bankruptcy law and other regulations that pre-date them. In many cases, the court battles being fought by these agencies to hang on to powers to seize and sell assets of those violating their rules are derailing a 270-day resolution deadline set by the insolvency law. Time-bound resolutions under bankruptcy law are the key to cleaning up $190bn stressed loans quickly as it helps banks to dodge higher provisions attached to missing resolution timelines. Judicial rulings against the laws in cases fought by regulators can further constrain the battle against bad loans and hinder Prime Minister Narendra Modi’s efforts to boost the economy. (Bloomberg)

China to issue central bank bills in Hong Kong late June, PBOC says (WSJ)

ECB ‘ready and prepared’ to ease policy amid rising uncertainty (FT)

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