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US brick and mortar retailers facing increased pressure

by Luo Weixiao

Bankruptcy filings for brick and mortar retailers in US have been piling up in the recent three years and underperformed stores have closed aggressively to cut cost. US retailers have announced a total of 6,378 store closures this year, more than 5,864 closures for the full year 2018. Sears, once the biggest retailer in the US, filed for Chapter 11 last October after years of declining revenue and mounting debt. Mattress Firm, the number 1 mattress seller in US, filed for bankruptcy in the same month due to overexpansion and above-market rental cost.

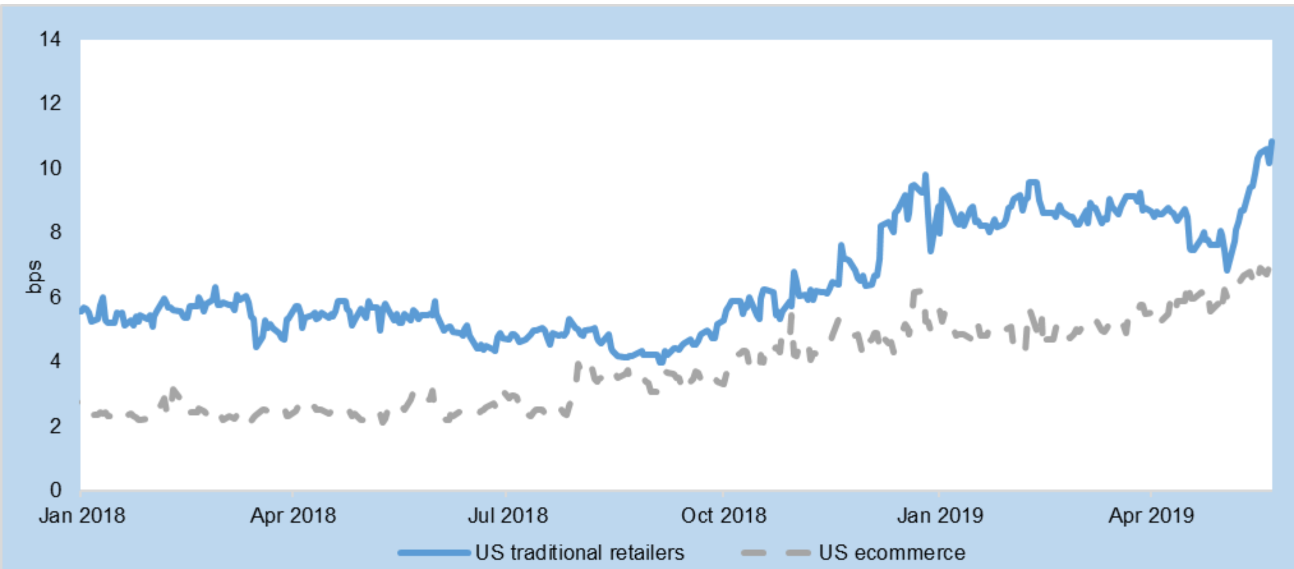

Figure 1: NUS-CRI Aggregate 1-year PD for US traditional retailers and US ecommerce (industry definition taken from Bloomberg). *Source: NUS-CRI*

The main reason for the retail apocalypse is the shift in consumer habits towards online shopping. The survivors in the retail industry are also struggling more than ever and the NUS-CRI 1-year Aggregate Probability of Default (Agg PD) of US traditional retailers reached the highest level since 2016 at 10.84bps, significantly higher than Agg PD of US ecommerce firms. The total share of non-store, or online US retail sales was higher than general merchandise sales for the first time in history, according to the Department of Commerce retail sales[1] report for February. The monthly retail sales by US online shoppers accounted for 12.10% of the total US retail sales in February 2019, compared to 11.62% made up by general merchandise sales. The higher percentage of online sales lasted in the later months, with 11.43% in March and 11.53% in April, higher than the portion of general merchandise sales. Some large traditional brick and mortar retailers are in the middle of their turnaround plan under the increased competition from ecommerce giants but it is still a long way to success as some of these retailers have reported lower-than-expected results in Q1 2019 which have added more pressure to their credit profile. On the top of the list is JC Penney.

[1] Retail sales estimates are based on data from the Monthly Retail Trade Survey and administrative records.

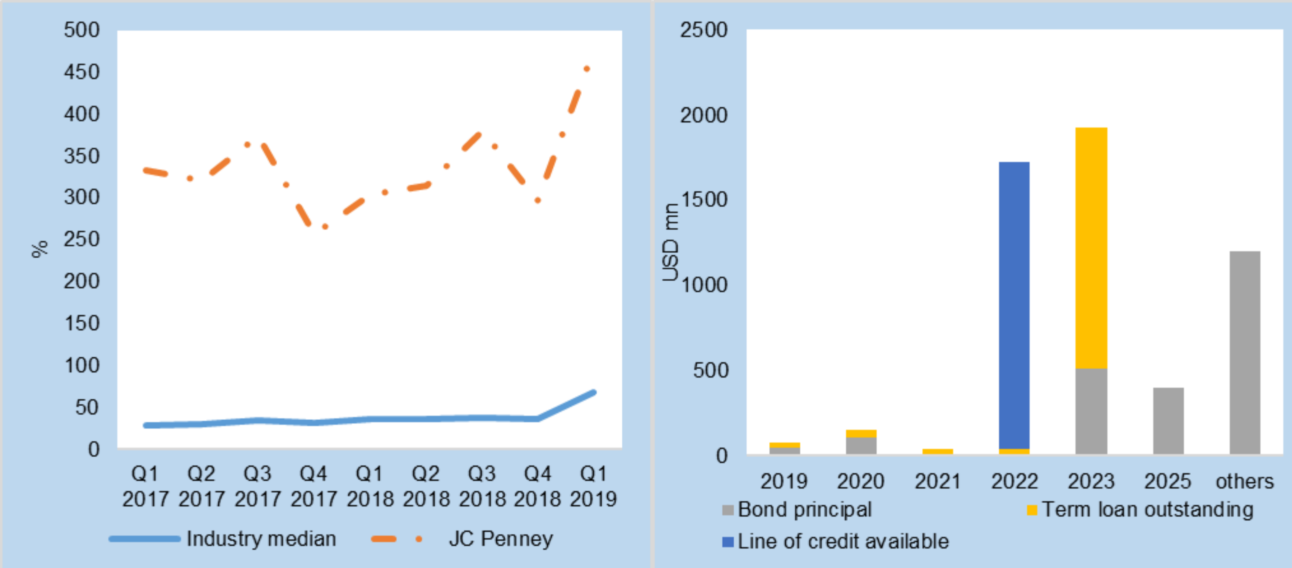

Figure 2a (LHS): Net debt to equity ratio for JC Penney and US brick and mortar retail industry median (industry definition taken from Bloomberg). Figure 2b (RHS): Debt maturity profile of JC Penney. *Source: Bloomberg*

JC Penney reported a further declining revenue and net income in the first quarter of 2019. The 117-year-old department store chain may be running out of time and capital to satisfy the changing consumer appetite. The chain cut off its major appliance business to focus on clothing but the mid-priced clothing and poor online shopping experience failed to attract consumers. Trailing 12-month revenue for the chain started to decline since 2018 and net income was negative even in the beginning of 2018 when Trump's tax cut plan took effect which boosted overall retail sales. In addition to its declining revenue and continuous negative cash flow and net income for more than two years, the credit outlook for JC Penney remains bleak amid the highly competitive retail industry with more store closures expected and its high debt, significantly higher than the industry median. Though the company has been actively repaying its debt maturing in 2019/2020, repayment pressure in the longer term is still high as around USD 2.1bn of debt will mature in 2023 and the chain has only USD 1.7bn line of credit available till 2022.

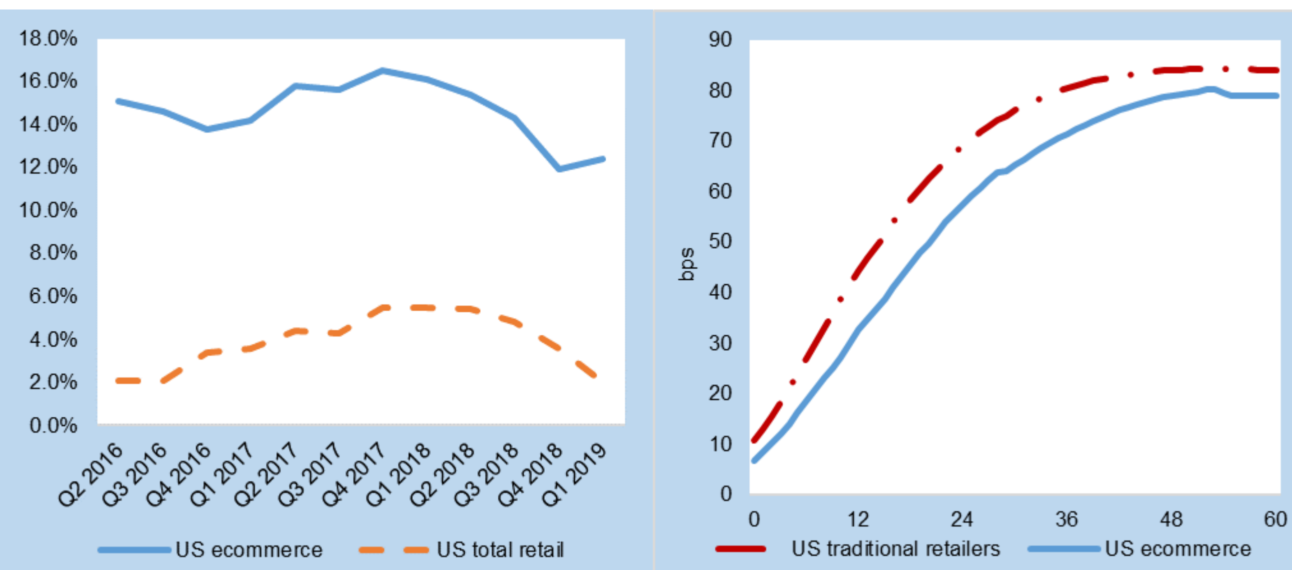

Figure 2a (LHS): Estimated US retail sales growth YoY. Figure 2b (RHS): NUS-CRI Aggregate Forward 1-year PD term structure for US traditional retailers and US ecommerce on 22 May 2019 (industry definition taken from Bloomberg). *Source: US Department of Commerce, NUS-CRI*

At the same time, estimated US total retail sales YoY growth compared to same period last year just dipped to its lowest level in the recent three years, standing at 2% in Q1 2019. The deceleration marked the fourth consecutive quarter of slowing sales growth and brick and mortar retailers have been hit hard by the slowdown. However, ecommerce sales headed to a different direction for the first time since 2017. Estimated ecommerce sales grew 12.4% YoY, rising from 11.9% last quarter. If the divergent sales between ecommerce and retail trend persists in the future quarters, traditional retailers which are not well prepared for online channels will face more challenges in the future. On the flip side, there are also traditional retailers that are offering more compelling experience and better online shopping options. Walmart and Target both invested into ecommerce to keep pace with leading online retailers like Amazon. Both retailers have been pushing customers to buy online and pick up in the store, saving on delivery expenses and hopefully enticing shoppers to buy more in stores when they retrieve online orders.

Looking ahead, the escalating US-China trade war may lead to further headwinds in the industry. Trump raised China's import tariff on some USD 200bn goods from 10% to 25%. On the list are consumer products such as luggage, mattresses, handbags, bicycles, vacuum cleaners and air conditioners. The Trump government also threatened to expand the list to an additional USD 325bn of goods, including toys, clothes, shoes and consumer electronics. Kohl's CFO said the rising tariff would primarily affect China-sourced merchandise, which accounts for 20% of their goods. UBS estimated the further tariffs in the trade war could lead to as many as 12,000 retail store closures and threaten USD 40bn in sales. As shown in NUS-CRI Forward 1-year Probability of Default (Forward 1-year PD), based on information available on 22 May 2019, credit profile will deteriorate in the coming three years before stabilizing. The Forward PD computes the credit risk of a company in a future period, which can be interpreted similar to a forward interest rate. For example, the 12-month Forward 1-year PD is the probability that the firm defaults during the period from 12 months onwards to 1 year plus 12 months, conditional on the firm's survival in the next 12 months.

Credit News

BoE staff highlight corporate bond market dangers

May 25. The Bank of England (BoE) has issued a warning about the rising level of high-risk investment-grade corporate bonds: while the sterling corporate bond market size increased sixfold since 1998, the share of BBB-rated bonds rose from 8% to 50% in the same time. According to the BoE, a downturn in the credit cycle would lead to an unprecedented number of downgrades into junk-status, forcing many investors bound to invest into investment-grade bonds only to suddenly sell. Dealers could be overwhelmed by the sudden influx of sellers, the BoE said, potentially deepening the impact of a market downturn. (FT)

Chinese regulator to take over Baoshang Bank due to credit risks

May 24. China's banking and insurance regulator will take over Baoshang Bank due to the serious credit risks it poses. The spotlight was on the bank due to one of its key stakeholder, Tomorrow Holdings, that was targeted in a government crackdown on systemic risks. This case shows how some of China's smaller regional lenders are dealing with deteriorating asset qualities, insufficient capital buffers and weak corporate governance. In the mid of the economy slowing down, this will add on to concerns regarding the stability of the country's financial system. A silver lining would be that principals and interest on personal savings account will still be guaranteed. (Business Times)

Fewer first-time defaulters in China

May 24. Improving funding environment in China through looser monetary policy, less strict shadow financing crackdown and reduced required reserves for rural commercial banks has reduced the number of first-time defaulters and is expected to improve companies' debt-repayment abilities. This could reduce investors' worries and bolster the broader corporate debt market. The improving funding conditions and more upcoming easing measures have also improved yields, evident in the spread between three-year AA rated bonds- which are considered junk in China- over similar government notes that have been shrinking to the narrowest since November 2016. (Business Times)

UK ports operator in test case for reform of floating-rate debt

May 23. In a first for the UK market, Associated British Ports (ABP), the biggest port operator in the UK, is trying to convince bondholders for changing GBP 65m of floating-rate debt to a different benchmark rate. Floating-rate bonds pay out varying instalments, which are in part determined relative to a benchmark rate. Until now, the LIBOR rate was used as the default benchmark rate for this task, but regulators are planning to phase it out from 2021 after recent scandals. An alternative benchmark rate could be UK-based Sonia, which is calculated on the basis of actual transactions instead of the LIBOR's trader submissions calculation. (FT)

Fed chair tempers fears over corporate debt meltdown

May 21. The booming USD 1.4tn market for leveraged loans – the practice of extending credit to low-rated, more indebted companies – has been the target of regulators as business debt reaches historic highs relative to the economy. A highly leveraged business sector could amplify economic downturn as companies are forced to lay off workers and cut back on investments. Fed chair Jay Powell has urged investors, financial institutions and regulators to focus on the risks today while times are good. Yet he also assures that the fundamentals of financial system today is strong enough to handle potential losses if the economy deteriorates. The business debt today, he argues, does not appear to present notable risks to financial stability as it did during the lead-up to the mortgage implosion in 2007-09 given debt to GDP ratio had been rising at a steady pace. Banks had also built up substantial loss-absorbing buffers. (FT)

LetterOne and Santander reach agreement over Dia debt (FT)

Wow Air collapse decimates Iceland's economy (Bloomberg)

Investors are diving back into South African corporate debt (Bloomberg)

Regulatory Updates

China prepares to open up bond futures market to domestic banks

May 23. Chinese regulators are shoring up to open trading of bond futures to domestic commercial banks. China is looking to increase hedging options and also to open up its markets to lure foreign investors into its USD 13tn bond market. The upcoming changes will not allow foreign investors to trade bond futures. However, with the introduction of new hedging instruments for Chinese banks, this would help boost liquidity and help with price discovery. Such actions will make conditions more favourable for foreign investors. Bond futures were introduced in 1995 but was closed due to the collapse of Shanghai Wanguo Securities. It was reopened in 2013 but with tighter oversight from regulators. (FT)

RBI to create specialised supervisory, regulatory cadre

May 21. The Reserve Bank of India has decided to create separate supervisory and regulatory cadre after reviewing the current economic situation, global and domestic challenges and various operating areas of the bank. The main objective behind this regulatory change is to strengthen the supervision and regulation of the commercial banks, urban cooperative banks and non-banking financial companies. It has also formed a committee to review the economic capital framework of the RBI. The committee will review the status, need and justification of various provisions, reserves and buffers presently provided by the RBI. (Business Times)

Bank of England considers tightening rules on mortgage lending (FT)

China cracks down on high-interest rate deposit schemes: sources (Business Times)

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Contributing Editor: Liu Hanlei