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China's biggest internet firms face heightened credit risk driven by regulatory crackdown

by Amrita Parab

- **The NUS-CRI Agg 1-year PD demonstrates a worsened outlook for Chinese internet firms as the government continues its crackdown on discriminatory practices and introduces tighter regulation for data security and protection**
- **Credit risk faced by Chinese internet firms is mitigated by favorable balance sheet positions and expansion into businesses deemed to be strategic by regulators**

The decision by Didi to delist from the US stock exchange, as well as news of a fresh batch of fines levied on internet giants like Alibaba, Baidu, and JD, underscore the fact that the Chinese government's crackdown on its domestic internet firms, which began in 2020, shows no signs of abating. The NUS-CRI Aggregate (market capitalization-weighted average) 1-year Probability of Default (Agg PD) of China domiciled internet firms[1] in Figure 1a showcases a concurrent increase in Agg PD stemming from intensifying regulatory actions, imposition of fines, and a slowdown in China's economy. The NUS-CRI Aggregate Forward 1-year PD[2] (Forward PD) for Chinese internet companies remains elevated as the industry is expected to continue to attract regulatory scrutiny (See Figure 1b). However, with internet firms actively diversifying their business segments, their credit outlook may stabilize, but remain elevated, in the long term.

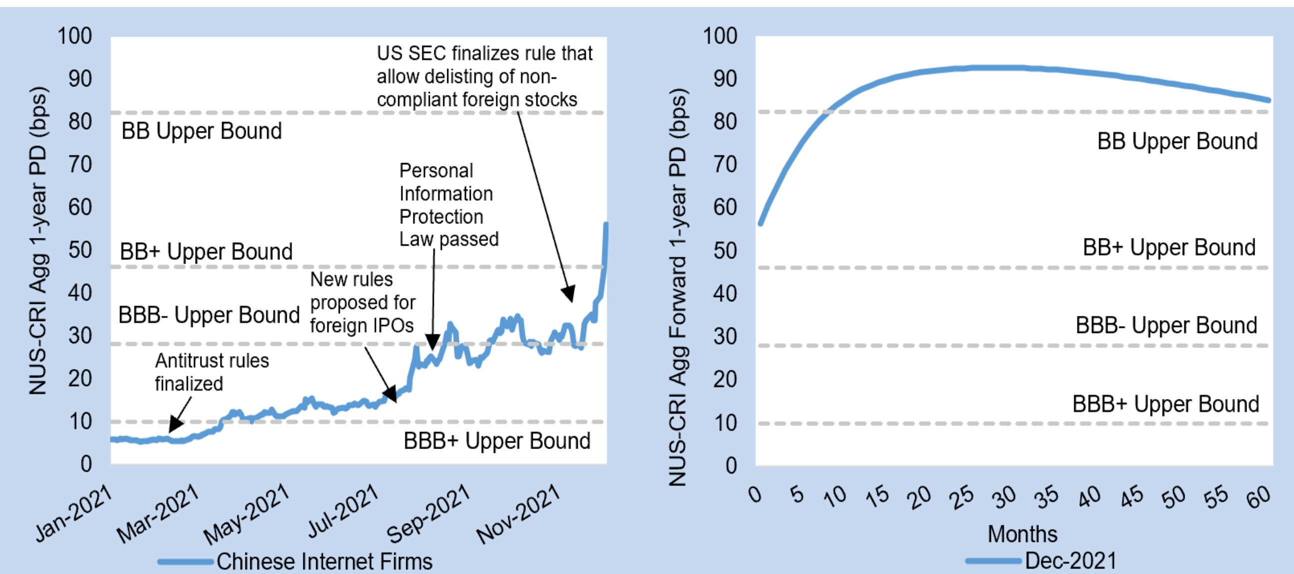

Figure 1a (LHS): NUS-CRI Agg (market capitalization weighted average) 1-year PD for Chinese internet firms from Jan-2021 to Nov-2021 with reference to PDiR2.0[3] bounds; Figure 1b (RHS): NUS-CRI Agg (market capitalization weighted average) Forward 1-year PD for Chinese internet firms as of Dec-2021 with reference to PDiR2.0 bounds. *Source: NUS-CRI*

The tighter regulations, combined with a slowdown in the Chinese economy, are further hurting the profit margins of internet firms. As most of the regulations were aimed at reining in discriminatory practices followed by larger firms, they have suffered a greater financial impact. In Q3 2021, Tencent's revenue grew at the slowest pace since 2004, while Alibaba reported its first profit decline in 5 years. In addition, Meituan reported a loss driven by the USD 530mn fine imposed for antitrust violations. Chinese internet firms have also borne the brunt of wider

[1] The sample consists of 133 companies with firms like Tencent, Alibaba, Meituan, Pinduoduo, JD.com, Baidu, Kuaishou accounting for the majority of the market weight.
[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.

crackdowns on real estate, insurance, and educational industries in the form of declining advertising revenue. Additionally, in the latest draft regulations unveiled in Nov-2021, regulators laid out plans to impose more stringent regulations on online advertising content. These measures may further weaken the revenue prospects of companies like Baidu and Tencent, which rely heavily on advertising revenue. The scrutiny and regulations[4] surrounding internet firms are expected to persist, forcing them to change the way they conduct business and increasing costs associated with compliance and revenue regeneration.

Furthermore, internet firms' access to foreign capital is also under threat. In Dec-2021, US regulators unveiled their plan for a new law that requires foreign companies listed on US stock exchanges to allow inspection by US auditors or risk forceful delisting. These developments raise the possibility of more delistings, especially for Chinese internet firms listed in the US. Although firms may still be able to relist on alternative exchanges, such as the Hong Kong exchange, they will be subject to stricter regulations and lower valuations than those available in the US markets[5]. Those wanting to list on the Hong Kong exchange may be required to undergo a cybersecurity review to assess their impact on China's domestic national security. Furthermore, many firms which are currently listed in the US do not meet the criteria for a Hong Kong listing. A potential delisting may severely curtail these firms' access to capital and make it difficult to attract foreign investors, who might stay away from the uncertainty brought upon by Beijing's increasing regulatory intervention.

	Q2 2020	Q3 2020	Q4 2020	Q1 2021	Q2 2021	Q3 2021
Current Ratio	1.94x	1.93x	2.01x	2.21x	2.01x	2.18x
Debt to Capital (%)	15.59	14.41	15.32	11.36	11.42	10.94

Table 1: Financial ratios (median) of Chinese Internet firms. Source: *Bloomberg*

In spite of the regulatory headwinds, Chinese internet firms are supported by their strong liquidity and low leverage ratios (See Table 1). At the same time, they are stepping up capital expenditures in order to build out alternative business lines, which are currently relatively insulated from regulatory action and provide diversification and growth opportunities for firms' revenue streams. Internet giants Tencent and Alibaba are focusing expansion efforts on areas of cloud computing and semiconductors, which are of strategic importance for the Chinese government. Diversification efforts by internet giants may have been accelerated in light of the recent crackdown witnessed in the industry. However, the uncertainty regarding the impact of expanding into new business lines may contribute to heightened risk on the firms' financial health, as depicted by the increasing Forward PD in Figure 1b, especially as the transition picks up steam. For example, Meituan and Pinduoduo absorbed losses in Q2 2021 as they diversified operations into building their community group buying segments.

With demand slowing amidst lockdowns across the country and incessant rounds of regulations, the profits of these internet firms are set to dampen in the near future. Additionally, the possibility of losing an important source of funding adds to the uncertainty regarding financing channels for the industry. As the internet firms navigate the regulatory hurdles posed by authorities, they may be supported by their stable financial health and diversification efforts, which may concurrently offset the impact of some of the regulatory risks they face in the long term, as demonstrated by the relative stabilization of the Forward PD over the 60-month horizon.

[4] The Personal Information Protection Law (PIPL), which was passed in Aug-2021, establishes rules around data collection and protection.
[5] For example, regulatory authorities have stated that any company which deals in data of more than 1 mn users must undergo approval before seeking listing in foreign countries.

Credit News

Chinese developer Kaisa on course for default after bondholders reject swap offer

Dec 3. Kaisa Group Holdings, China's first developer to default on dollar debt in 2015, is now at risk of defaulting again. The company had sought to exchange its USD 400mn of US dollar notes maturing on December 7 for new ones due 18 months later, but failed to reach the required 95% approval rate from bondholders. A debt restructuring is expected as Kaisa may not repay this debt. Moreover, such defaults may also trigger cross-defaults on other debts. Kaisa's broader debt obligations, especially the offshore notes that make up most of its public bonds, remain to be resolved. Prohibitively high borrowing costs in the offshore credit market make it near-impossible to refinance dollar debt. Therefore, the company may accelerate the disposal of real estate projects and high-quality assets to improve liquidity as it has USD 2.8bn in offshore notes maturing next year. (Straits Times)

Bond market flashes warning sign over global economic growth

Dec 2. Bond markets are sending out warning signals about the global growth prospects, as inflation fears and the spread of the Omicron coronavirus strain change investor expectations. Short-term bonds have been under fresh pressure globally since Fed chair Jay Powell indicated on Tuesday that the Fed's asset purchases might be reduced more quickly, potentially paving the way for earlier interest rate hikes. While the prospect of tighter monetary policy has weighed on short-term debt, longer-term bonds have surged as the threat of a new wave of coronavirus infections heightens fears about global economic growth. The spread between the ten-year and two-year US government bond rates shrank to only 0.82 percentage points, the smallest since January. The current flattening is fueled by concerns that rising energy costs, a rumbling property crisis in China, and the emergence of the Omicron variant might cause a significant slowdown in the global recovery in 2022. (FT)

More Chinese developers seek domestic bond issuance

Dec 2. Three Chinese developers plan to sell bonds in China to raise a total of CNY 18bn, indicating that Beijing is easing liquidity strains on the debt-ridden sector. Early this year, China tightened lending restrictions on the real estate sector, increasing financial troubles and causing sector-wide liquidity stress. However, in Nov-2021, corporate bonds issued by real estate companies nearly tripled from the previous month to CNY 37.1bn. Furthermore, financial regulators instructed several Chinese banks to offer more loans to property businesses for project development. However, the Chinese government has not indicated that the "three red lines" will be relaxed. Despite recent policy changes, analysts believe Beijing will continue its push to deleverage developers. (Reuters)

US junk bonds hit by sharpest sell-off in more than a year

Dec 1. US junk bonds fell in November by the most in more than a year on fears that the spread of the Omicron variant will hinder the ability of low-rated companies to repay their debts. The bonds of CCC and lower-rated companies returned minus 1.4 percent, reflecting worries that tightening monetary policy or stricter social curbs could affect the financing for risky companies. Much of the downturn came on Friday last week, as governments rushed to reimpose restrictions. Yet, investors had already grown cautious earlier in November, as high inflation and decelerating economic growth led to calls for the Federal Reserve to step back from its pandemic-era bond-buying program faster than planned. (FT)

Credit funds signal more pain as record cash swamps treasury ETF

Dec 5. As the equity markets came under pressure from omicron fears and the prospect that the Fed may begin tapering bond purchases sooner than expected, a record of USD 2.5bn was poured into the iShares 20+ Year Treasury Bond ETF. In contrast, investor sentiment on corporate debt turned negative as investors pulled close to USD 4bn from the US investment-grade bond funds for the week ended Dec 1, while a selloff occurred on the iShares iBoxx High Yield Corporate Bond ETF for the third consecutive week. Meanwhile, the S&P 500 fell for the second straight week, dragged down by a selloff in the tech sector. However, investors are expected to return to the equity markets in the future once the turbulence caused by the pandemic subsides. (Bloomberg)

U.S. junk bond funds see biggest outflows in 8 months in November (Reuters)

China developer Sunshine 100 defaults on USD 170mn of bonds (Bloomberg)

Bond market's faith in fed set for biggest test since the 1980s (Bloomberg)

Regulatory Updates

ECB governors mull delaying call on future bond buys as outlook murky

Dec 1. As the Omicron coronavirus and rising inflation cloud economic outlook, more ECB governors are mulling over postponing some of the ECB's stimulus measures. The ECB's Governing Council will meet on Dec 16 to determine whether to stop its Pandemic Emergency Purchase Program (PEPP) in March and how much debt to purchase after that to keep inflation at the target 2%. Although President Lagarde has repeatedly stated that the PEPP will end in March, some governors would like not to decide beyond March until the next policy meeting on Feb 3, when more information about the Omicron variant and the inflation outlook will be available. ECB's Executive Board is likely to oppose them as it is currently set for informing guidance in December and may be wary of upsetting bond investors seeking reassurance. Another option, given market pressures, was to outline plans in December only for the first few months after PEPP ends, allowing policymakers to revisit their decision in early 2022. (Reuters)

Companies cling to Libor as key deadline nears

Dec 3. By the end of December, US corporations must abandon the London interbank offered rate (Libor). After which, banks will not be able to issue new loans or other financial contracts using Libor. However, they can reference Libor for debt issued through Jun-2023. Whilst regulators have been pressuring lenders to reduce exposure to Libor, companies have continued utilizing Libor to launch new leveraged-loan transactions in recent weeks. Although many corporations are expected to migrate to using the Secured Overnight Financing Rate (SOFR), which is the favored Libor substitute, most have been slow to move away from Libor. Junk-rated corporate loans issued using SOFR this year amounted to only 1.7% of the USD 595bn in total sales. (WSJ)

RBI may hold on to rates amid virus risk (Mint)

Watching inflation like a hawk, the Fed might cut economic aid faster (New York Times)

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