China's tech giant Meituan, once credit-strong, now faces headwinds from regulatory challenges and aggressive expansion

by Wang Anyi

- **Amidst waves of regulatory crackdowns, the credit risk of Meituan is set to increase by around 30bps over the next 3 years, as indicated by the NUS-CRI Forward 1-year PD**
- **Continued losses in new businesses, increased costs, and higher leverage could also pose potential headwinds for Meituan's credit outlook**

Meituan, the largest food delivery company and leading e-commerce platform for local services in China, is the second tech giant that faces an antitrust probe by regulators after Alibaba was hit with a record fine of USD 2.8bn for violating antitrust law, bringing Meituan's financial health under the spotlight in recent months. As showcased by the NUS-CRI 1-year Probability of Default (PD), Meituan used to be credit-strong with its PD hovering under 1bps, with the company benefiting from ample liquidity and low leverage. However, its credit risk has worsened since the end of Apr-2021, when the Chinese government opened an antitrust probe on the company's operations, nearing the BBB+ upper bound with reference to PDiR2.0[1]. The credit outlook of Meituan has also further worsened since then, with the NUS-CRI Forward 1-year PD (Forward PD[2]) demonstrating heightened short-to-medium term credit risk currently, compared to Jan-2021, amid continued losses in the company's new business segments, like Meituan Select, and increased costs due to the ongoing regulatory changes.

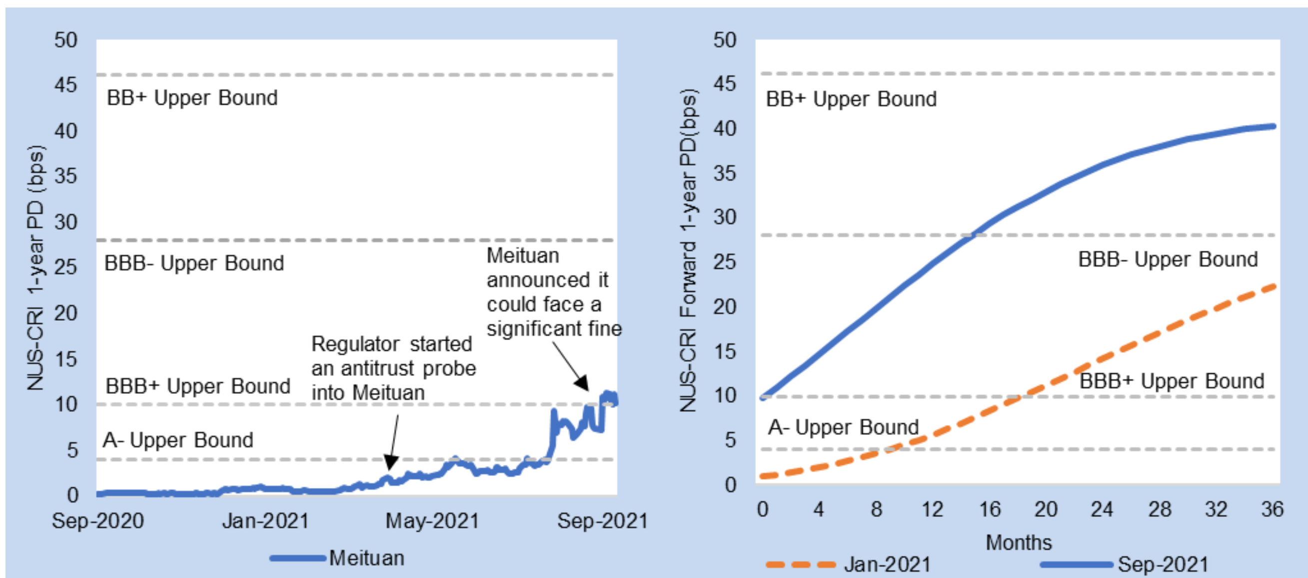

Figure 1a (LHS): NUS-CRI 1-year PD for Meituan from Sep-2020 to Sep-2021 with reference to PDiR2.0 bound. Figure 1b (RHS): NUS-CRI Forward 1-year PD for Meituan over the next 36 months as of Sep-2021 and Jan-2021 with reference to PDiR2.0 bound. *Source: NUS-CRI*

Regulatory pressures on Meituan have intensified since April. On April 26th, China's State Administration for Market Regulation (SAMR) started an antitrust probe into Meituan for abusing its dominant market position to the detriment of its competitors. A potential fine by SAMR of roughly USD 1bn would deteriorate Meituan's cash position this year, with the fine being equivalent to around 77% of the company's CFO reported last year.

[1] 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.

[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, conditional on the firm's survival in the next 6 months.

Recently, SAMR also launched an investigation on Meituan for failing to report the USD 2.7bn acquisition of Mobike in 2018. Facing a wave of regulatory crackdowns, Meituan may be subject to substantial fines in the near future, which could burden the company's financial health.

Aside from the regulatory challenges, Meituan also faces problems stemming from its own operations. Despite a short history of profitability, the company partakes in aggressive investment in its expanding business initiatives. Since last year, Meituan has continued to ramp up investment in the e-commerce space, particularly its community e-commerce business Meituan Select. With this business segment operating in its early stages, Meituan has been amassing more leverage to support its financing needs. In 2020 alone, Meituan's total debt to equity ratio increased from 6.04% in Q1 to 24.64% in Q4. Furthermore, in Apr-2021, Meituan raised USD 3bn of convertible bonds to fund R&D for drone delivery and new business investments. Now, as of Q2 2021, its total debt to equity ratio stands at 39.40%, with the company's total debt to EBITDA soaring to 17.77 (See Figure 2a). To establish a leading market position, Meituan's current aggressive investment approach is expected to continue moving forward. The upfront investment in logistics and warehousing could further dampen Meituan's free cash flow and erode its cash position, potentially leading to increased debt issuance.

For Meituan, the community e-commerce segment has a strategic significance and high long-term growth potential, however, the competition in this particular business segment is red-hot, with Alibaba, Pinduoduo, and Didi Chuxing also actively investing in it. Despite Meituan's investment, the new business initiatives have thus far brought Meituan considerable losses. In 2020, Meituan suffered an operating loss of CNY 10.9bn driven collectively by the operations of the company's new initiatives, compared to a CNY 6.7bn loss in 2019. Additionally, the operating margin for this segment dropped to -64.9% in Q4 2020, with operating losses expected to continue over upcoming quarters. This can be reflected by the plunge in the company's EBITDA margin in Q2 2021, which has been steadily declining since Q3 2020 (See Figure 2a).

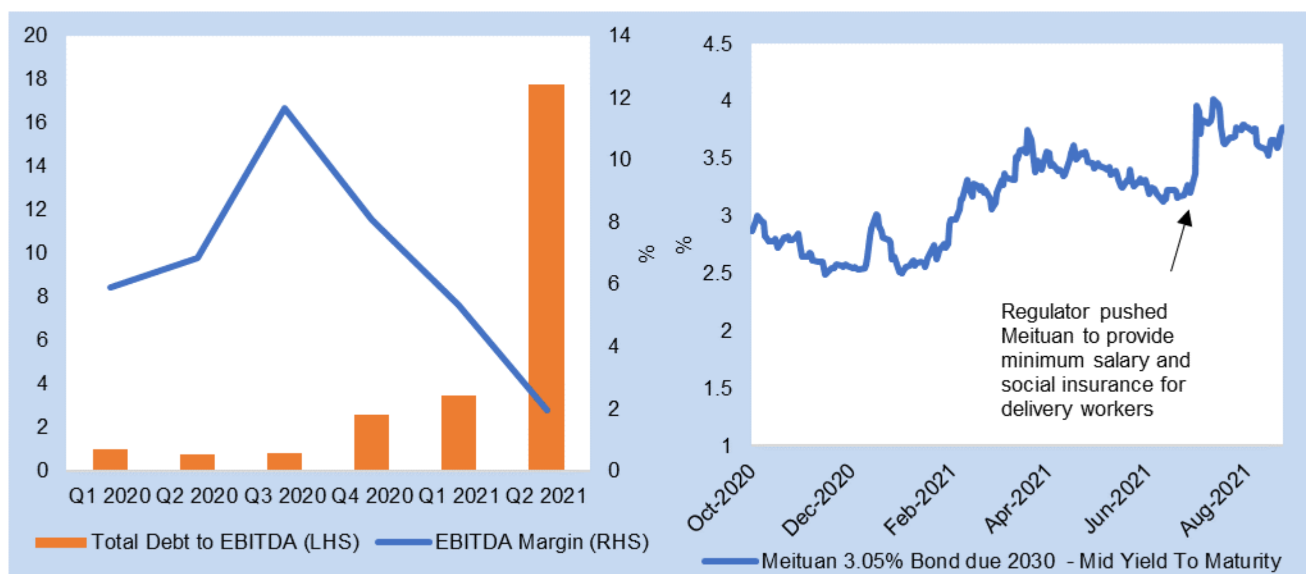

Figure 2a (LHS): Total Debt to EBITDA and EBITDA Margin of Meituan from Q1 2020 to Q2 2021. Figure 2b (RHS): Mid Yield To Maturity of Meituan 3.05% bond due 2030 from issue date in Oct-2020 to Sep-2021[3]. *Source: Bloomberg*

Looking forward, Meituan's profitable food delivery service may also incur higher costs due to new regulations. On 26 July, SAMR published new guidelines to push online platforms to protect basic labor rights for riders, including a base income, work safety, food safety, a decent working environment, and access to insurance coverage. This could be a financial blow to Meituan as it may greatly increase the cost of food delivery operations and impair profitability, weighing in on Meituan's creditworthiness as reflected by the elevated borrowing cost in Figure 2b. Moreover, the Chinese government's soft tax stance on the internet industry is set to come to an end, putting a stop to the tax breaks companies in the internet industry have enjoyed in the past. Previously, companies used to grow uninhibitedly by benefitting from lax regulatory oversight. However, as the government is tightening regulations in the internet industry, the regulatory risks are expected to persist over the next few years, adding pressure to Meituan's worsening credit outlook.

Continued investments and sustained losses make it necessary for Meituan to secure funding sources in the future. The borrowing cost has increased for Meituan compared to last year despite the low interest rate environment (See Figure 2b), demonstrating the weakened investor confidence in its creditworthiness. With debt

[3] After the Chinese regulator ordered online platforms to provide at least local minimum wage on July 26, Meituan's stock price and dollar bond plummeted.

borrowing becoming more expensive, Meituan may need to seek non-debt funding. Meituan's stock value, however, has also slid by nearly 50% from its peak in Feb-2021, driven by concerns surrounding regulatory crackdowns. That being said, Meituan's current strong cash positions, resulting from the equity issuance in Apr-2021, might be able to provide a buffer for potential fines and increased costs in the short term. Its dominant position in food delivery services and in-store, hotel & travel services has been generating stable and considerable returns which may partially mitigate the losses in the company's new initiatives. The risks, however, still remain should Meituan fail to improve margins in its new business. The aggressive expansion, combined with regulatory challenges, would therefore pose strong headwinds for Meituan in the years to come.

Credit News

Evergrande moment of truth arrives with bond payment deadlines

Sep 19. Interest payments on two Evergrande notes are due on Thursday, posing a critical test of the developer's ability to meet bondholder obligations while falling behind on payments to banks, suppliers, and onshore investment product holders. With one of the notes trading for less than 30% of face value, investors are pricing in a substantial risk of default. On the same day, Evergrande is required to pay a USD 36mn coupon on an onshore bond. However, a missed payment has a 30-day grace period before it is considered a default. Meanwhile, other real estate companies' stock prices have plummeted, while the yield on a dollar-denominated junk bond index has surged to nearly 14%, the highest in nearly a decade. On Friday, the People's Bank of China injected USD 14bn in short-term cash into the financial system in a bid to calm markets. Evergrande will also pay bank loan interest on Monday, with a one-day grace period. Chinese authorities have already informed big lenders not to anticipate repayment, as Evergrande and banks are exploring the prospect of loan extensions and rollovers. (Bloomberg)

Stymied bond bears see spark for higher yields in pivotal week

Sep 19. The bond market enters a crucial week as the Federal Open Market Committee is expected to provide clues regarding its plan to taper bond buying. The meeting is expected to possibly trigger a breakout in yields, with dealers anticipating the 10-year rates to climb approximately 30 basis points higher by end of the year. In addition to Fed tapering, eyes will also be on the central banks forecast for its benchmark rate. A hawkish shift in the projection of the benchmark rate may trigger a sell-off especially in 5 and 10-year Treasuries. The possibility of a hawkish shift has already lead to the shrinking of 5 and 30-year treasury yield spreads. (Bloomberg)

High yields tempt wary investors back into Turkish debt

Sep 17. Following the damage caused by the firing of Turkey's central bank governor Naci Agbal in March, foreign investors have started to return to Turkey's debt market, recording a $2.25bn sale of Turkish dollar bonds. The enticing high yields of Turkish debt attracted investors despite political risks that could threaten the stability of the financial markets. Dollar-denominated 12-year Turkish bonds were issued at a yield of 6.5%, higher than the 5% yield on emerging market bonds, while lira-denominated 10-year Turkish debt provided even higher yields of 16% against the 1.3% yield offered by 10-year US Treasuries. However, concerns regarding the Turkish current account deficit and high inflation rates remain, with international investors only holding about 4% of the nation's local government bonds, compared to 25% in 2013. (FT)

Junk-debt sales soar toward record year

Sep 19. The USD 3tn market for low-rated company debt is experiencing its greatest year on the back of a strengthening economy and investors' desire for additional yield. The record issuance is a significant improvement over Mar-2020 when investors' concerns about bankruptcies and defaults caused low-rated debt prices to plummet. Low interest rates, coupled with a stimulus-fueled economic recovery that has aided companies with lower credit ratings, have increased the appetite for riskier debt. Companies are taking advantage of low interest rates to refinance higher-cost debt, decreasing their interest expenses and deferring repayment. The rise in junk debt is one indicator that investors are letting go of their concerns about recent inflation, which erodes the purchasing power of fixed-income bonds and prompts increased interest rates. Other corporations are issuing low-rated bonds to pay for mergers and acquisitions, which is a major source of market supply. Many businesses have taken advantage of recent sales to prolong the term of their debt, lowering their annual interest costs. However, analysts believe that signs that the United States' economic recovery is weakening will continue to cause volatility in the short term (WSJ)

China link gives Hong Kong a boost in bond trading

Sep 17. As a result of a scheme that will further open the market to mainland Chinese investors, Hong Kong is set to become a larger center for trading and issuing bonds. The program is the latest illustration of Beijing's backing for Hong Kong as a financial center, by providing more chances for the city to serve as a gateway between China and global markets. The southbound Bond Connect will join a northbound counterpart that

launched in 2017, as well as a similar two-way stock-market program called Stock Connect, and a newly announced wealth-management link for private investors. The northbound bond connection has already allowed global investors to collect USD 170bn in onshore bonds since 2017. China is gradually loosening its hold on investment streaming in and out of the mainland through the Bond Connect and its sister initiatives. Opening up outbound avenues helps to counteract the yuan's potential strengthening impact. As a result, companies from all over the world have already gone to Hong Kong to raise debt. (WSJ)

Algosaibi family looks to rebuild after USD 7.5bn debt deal (Bloomberg)

Oil trader gunvor to tap bond market for first time since 2013 (Bloomberg)

Banca Generali writes down pandemic-hit healthcare bonds (FT)

Regulatory Updates

Powell is moving closer to a dial-back in stimulus

Sep 19. Fed Chair Jerome Powell is expected to announce the start of slowing bond purchases in an official announcement in November, while convincing Americans and investors that the bond tapering will not be followed by rising interest rates. The decision to pull back pandemic-driven came with considerations regarding the strength of economic growth and inflationary pressures. More official announcements in September include Canada and Germany's national elections and policy statements from Japan, Australia, Norway, Switzerland, and South Africa. (Bloomberg)

Big milestone in Libor demise has barely budged the loan market

Sep 17. Following a rigging scandal a decade ago, new loan sales from January 2022 will no longer be tied to the London interbank offered rate (Libor). However, plans to replace the Libor with the Secured Overnight Financing Rate (SOFR) have been slow, with only a few borrowers issuing new loans benchmarked to the SOFR. On the other hand, the SOFR derivatives trading saw a rise from 7.4% in July to 12.5% of the dollar market in August. This could be a positive boost for the transition to the new benchmark rate as banks and lenders utilize the derivatives market to hedge their risks. The reasons for the slow switch from Libor are due to cost differences in selling loans with different benchmark rates and the relatively late endorsement of the SOFR as a replacement for LIBOR. (Bloomberg)

African central banks seen holding rates on GDP growth concerns (Bloomberg)

China forms cross-agency team to crack down on securities misbehaviour (Reuters)

Published weekly by Credit Research Initiative – NUS | Disclaimer
Contributing Editors: Yao Xuan, Raghav Mathur