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COVID-19 triggers a widening gap between brick and mortar and e-commerce retailers' credit profile

by Tsoi Yuet Yan

The COVID-19 pandemic which placed one third of the global population under lockdown has inevitably hurt global businesses. We see an intentional shift in consumer behaviour as people increasingly purchased goods and services online to reduce their exposure to crowds as much as possible as advised by many local authorities. Since the lockdown in Wuhan and other coronavirus hot spots, the impact of COVID-19 on the NUS-CRI Aggregate 1-year Probability of Default (Agg PD) of brick and mortar and e-commerce firms have similar trends but on different scales. Comparing the historical Agg PD of brick and mortar firms and e-commerce firms, the news of the outbreak of the coronavirus in late December 2019 had led to further divergence in the Agg PD of the brick and mortar from that of e-commerce. The Agg PD of brick and mortar firms remained higher than that of e-commerce ever since, but the gap widened in late March after the coronavirus outbreak became globalised with dozens of countries reporting their first cases and the number of deaths surpassing 10,000.

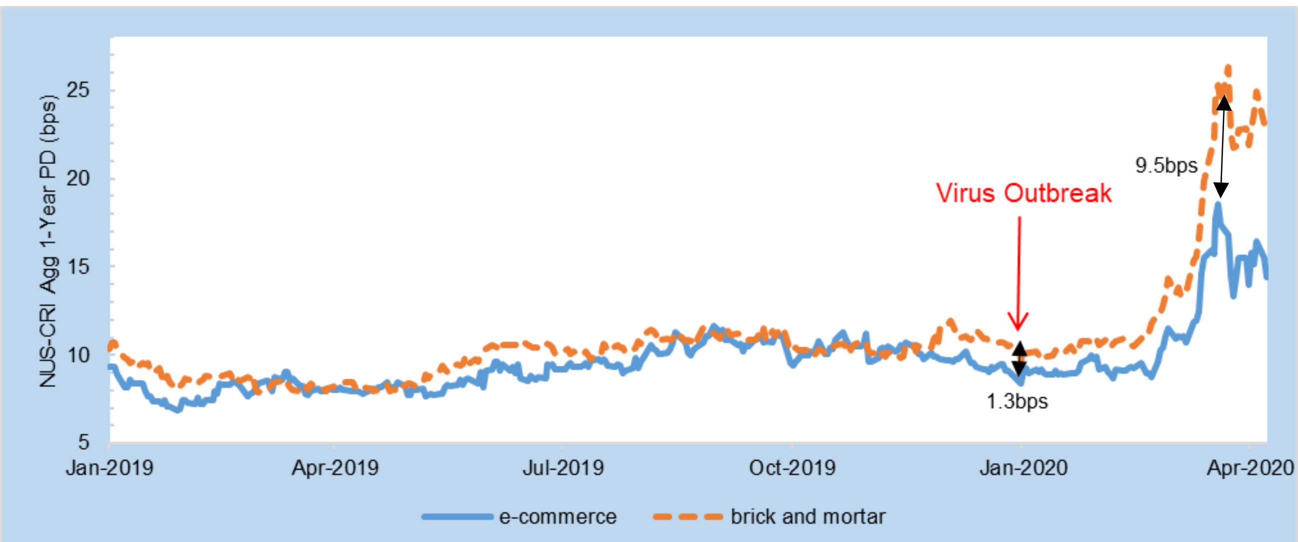

Figure 1: NUS-CRI Aggregate 1-Year PD for globally listed brick and mortar and e-commerce firms from January 2019. *Source: NUS-CRI*

Throughout 2019, the Agg PD of brick and mortar and e-commerce firms were closely related, keeping within a close range of 1-2bps from each other. In late December, the difference was 1.3bps. However, in Mar 2020, the Agg PD of brick and mortar firms increased to a peak of 26.3bps from 13.5bps while e-commerce firms increased to a peak of 18.5bps from 10.9bps. The widest difference in mid-March was 9.5bps while a sustained gap of 8bps on average remained between brick and mortar and e-commerce firms till today. The rise in PD for the former is also steeper and greater. This is so as the increase in number of states announcing a lockdown would inevitably pose liquidity and cost stress for physical stores whose fixed costs such as rent and wages continue to accumulate despite the low traffic flow. For example, in the UK, footfall across its bricks-and-mortar destinations fell 81.4% in the week beginning 29 March and a report by Alvarez & Marsal (A&M) in collaboration with Retail Economics has projected that a 10% reduction in sales would have resulted in more than two-thirds of large UK retailers falling into negative cash flow, and so far the lockdown in UK had already caused sales to drop as much as 70%. Meanwhile, global online retail sales has risen dramatically with a 74% growth in transaction values compared to the same period last year.

Just last May, we highlighted the pressure being faced by US brick and mortar firms from the increasing popularity of e-commerce. However, the brick and mortar industry rebounded quickly in the second half of 2019 in the global low interest rate environment and stabilising trade relations between US and China. Yet, just when the PD of brick and mortar firms settled down, the pandemic has created yet another crisis, this time more serious and enduring. As evident from the NUS-CRI Forward 1-year Probability of Default (Forward PD) time series, the probabilities for brick and mortar firms to default between Dec 2020 and Dec 2021 based on the available information from different periods of the pandemic (December 2019 - April 2020), are consistently higher than those for e-commerce firms. More importantly, we note that since the coronavirus outbreak in late Dec 2019, the Forward PD for brick and mortar firms increased more steeply compared to that of e-commerce firms. Focusing on late March, where the situation escalated to a pandemic and many countries announced lockdown, the Forward PD of brick and mortar firms rose more steeply and steered away from that of e-commerce firms. This shows that the credit profiles of brick and mortar firms are more vulnerable compared to that of e-commerce firms in these challenging times.

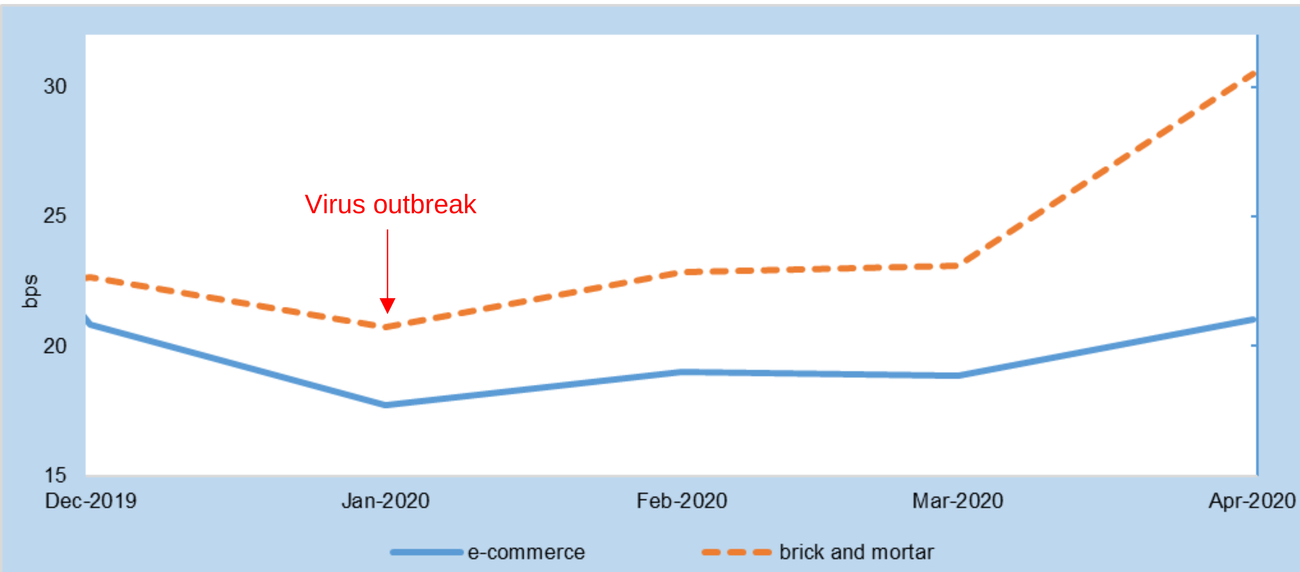

Figure 2: NUS-CRI Aggregate Forward 1-Year PD time series for globally listed brick and mortar and e-commerce firms based on information from different historical months looking to December 2020. *Source: NUS-CRI.*

The impact of the coronavirus outbreak on weaker and stronger brick and mortar and e-commerce firms also varies. As can be seen from the chart below, the bottom quartile (bottom 25 percentile) of brick and mortar firms have weakened significantly with former more than the latter. They saw an increase of 106 bps and 70bps respectively. At the same time the top quartile for both saw negligible change at less than 1bps. This is not surprising as the top quartile companies in both segments of the retail industry are much better positioned to withstand the challenging environment. This cannot be said of the bottom quartile.

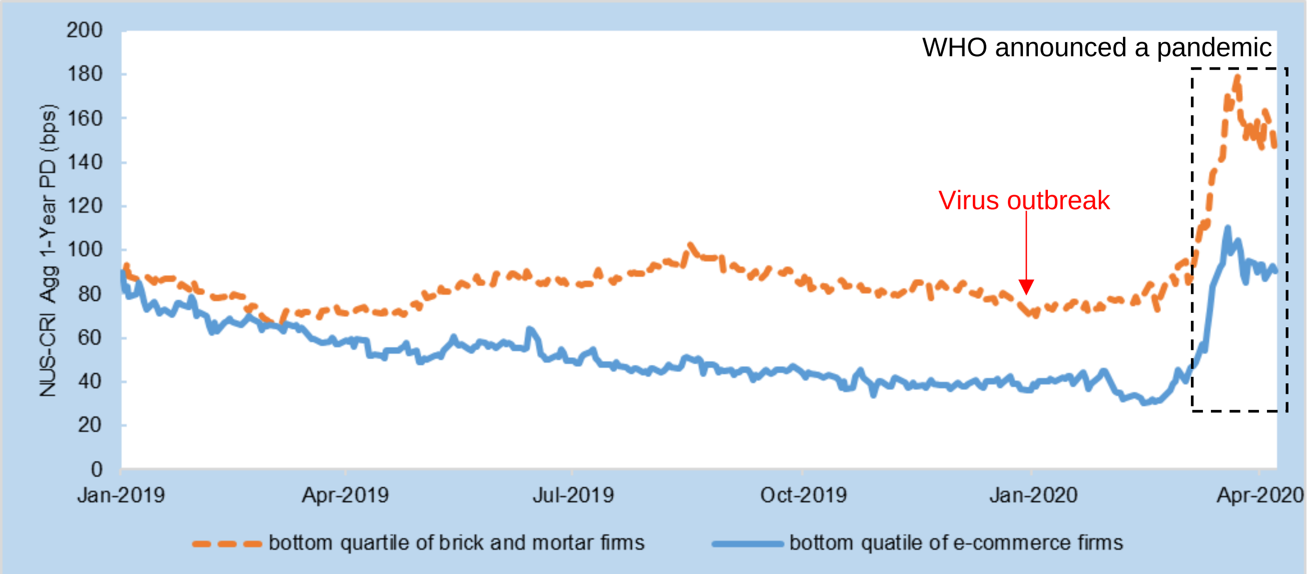

Figure 3: NUS-CRI Aggregate 1-Year PD for bottom quartile (bottom 25 percentile) globally listed brick and mortar and e-commerce firms from January 2019. *Source: NUS-CRI*

Meanwhile, comparing the credit profiles of the bottom quartile of both industries, we see that post-outbreak, the increase in PD of brick and mortar firms is much greater and more volatile compared to that of e-commerce firms. The PD of the bottom quartile e-commerce firms still showed signs of recovery in February before the outbreak escalated to a pandemic. Hence, this also shows that the credit profiles of brick and mortar firms are more volatile in relation to e-commerce firms of the same high-risk quartile.

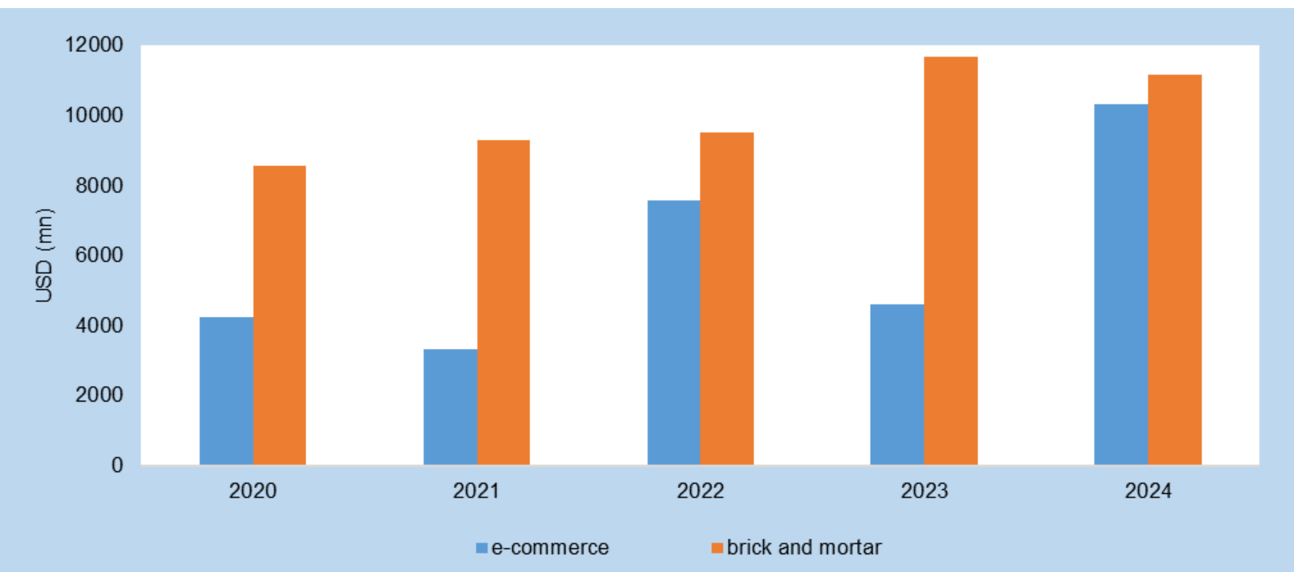

Figure 4: Bond maturity profile for globally listed brick and mortar and e-commerce firms. *Source: Bloomberg*

Due to differences in their business models and being more capital intensive, brick and mortar firms in general are expected to have higher bond issuances and debts. As seen from Figure 4 above, the total amount of bond maturing for brick and mortar firms is higher than that of e-commerce firms for the next 5 years. Therefore, by the difference in business nature, we see a stark difference in how the pandemic affects the credit profiles of brick and mortar and e-commerce firms. Fundamentally, the asset light e-commerce model would be able to cope much better. Moreover, should the brick and mortar industry face additional stress in future crisis, we see a potential high amount of debt at risk. Looking forward, brick and mortar firms which have not already taken this opportunity to shift some of their sales online, might want to consider diversifying so as to maintain a healthy and stable credit profile in the long run.

Credit News

Oil price war ends with historic OPEC+ deal to cut output

Apr 13. The global oil price war was finally put to an end with an OPEC+ deal that requires to cut global petroleum output by 9.7 million barrels a day, which is just 0.3 million barrels a day below the initial proposal. Shortly after settling the deal, prices rose more than 4% a barrel in London and Brent futures jumped 8% in Asia. However, questions remain whether the measures of the deal are sufficient enough to compensate for the oil demand loss as oil demand is expected to remain depressed as countries around the world extended their lockdown due to the coronavirus. (Bloomberg)

As credit markets rebound, neediest borrowers are left behind

Apr 11. The US junk-bond market has shown a recovery in recent days but not all borrowers are reaping the benefits equally. Risk premiums on bonds rated CCC remain near the widest since 2009 relative to securities a few notches higher in the B and BB buckets. According to analysts, the Federal Reserve's activity of buying debt downgraded to the highest junk tier could further exacerbate the divergence. The increasing disparity between speculative-grade issuers may signal that a wave of restructurings among the most leveraged firms is almost unavoidable, even as the global economy could turn the corner in the coming months. (Bloomberg)

CFOs under pressure to maintain liquidity as coronavirus inflicts economic damage

Apr 10. Financial chiefs are under pressure to maintain liquidity during the coronavirus pandemic. The lockdown of significant parts of the world economy is resulting in revenue declines for industries such as hotel operators, airlines, retailers and car manufacturers. Businesses also are navigating supply-chain disruption and a surge in costs related to the transition to remote work. The Fed has unveiled various measures to alleviate credit stress and provide firms with access to capital while CFOs are extending credit lines, bolstering emergency cash reserves and tapping bond markets. Meanwhile, companies are cutting expenses and looking to expand their capital buffers to survive. (WSJ)

Downgrades flood junk bond market with "fallen angels"

Apr 7. In March, a record of USD 90bn of debt was downgraded to junk status, including debt of issuers like Ford, Occidental and Macy's. Finding buyers for these fallen angels, i.e., bonds that are reduced to junk status from investment-grade could be challenging since the high-yield bond market of USD 1.2tn is much smaller than the USD 6.7tn investment-grade bond market. The average time to maturity of junk bonds rose from 5.8 to 6.1 years in February, which was partly due to newcomers of fallen angels, such as Kraft Heinz, that issued very long-term debt. Within the junk bond market, it is also hard to disentangle price changes that are caused by those fallen angels from general market movements. (FT)

Chinese corporate bond defaults drop 30% on bank aid

Apr 7. The amount of defaulted Chinese corporate bond dropped nearly 30% in the first quarter of 2020, compared with the number last year, since the government pressed banks to provide support in response to the coronavirus epidemic. Fewer defaults suggest bankruptcies will be averted in the short run and jobs will be saved just like what the government hoped. However, since the coronavirus outbreak in the US and Europe could be prolonged and thus hurting demand for Chinese-made goods, banks could be saddled with more nonperforming debt. Substantial risks remain in China's financial system, with the amount of debt at risk of nonperformance totaled CNY 3.8tn. (Nikkei Asian Review)

Giant Taiwan insurers seen stepping up purchases of dollar bonds (Bloomberg)

China Evergrande struggles to convince investors with debt-cut plan (Nikkei Asian Review)

Brazil SME stress test results "not very good" – central bank (Reuters)

Regulatory Updates

Federal Reserve enters new territory with support for risky debt

Apr 10. The Fed has announced plans to support debt issued by riskier companies in a radical addition to its crisis-fighting toolkit by purchasing shares in exchange-traded funds that own the debt. The move adds a new dimension to the central bank's effort to buttress the US economy, reflecting the scale of the coronavirus threat to markets and economies. In response to the Fed's move on Thursday, the biggest high-yield bond ETF jumped by more than 7%, the largest one-day move since 2008. The US central bank also expanded its existing credit facilities from a combined USD 200bn to USD 750bn. However, the expansion of the Fed's crisis-fighting toolkit will be controversial, with one investment industry insider arguing that it was tantamount to an indirect bailout of the private equity industry. (FT)

ECB makes it easier for banks to tap credit amid coronavirus crisis

Apr 8. The European Central Bank (ECB) took measures to make it easier for banks to borrow cash at rock bottom rates during the coronavirus crisis. It would ease the collateral requirements to help banks use its funding operations. For this purpose, collateral valuation haircuts are reduced by 20% and the ECB will also accept government guaranteed loans with lower credit quality as collateral, e.g., Greek government debt even though such papers are rated below investment grade. These measures will remain in force during the pandemic and be reviewed before the year's end. (Reuters)

China's central bank to step up easing, won't borrow from Fed playbook (Reuters)

Bank of England eases rules for credit unions during pandemic (Reuters)

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