Alibaba holds up against economic and regulatory challenges

by Lee Wei Qi

- **The Chinese antitrust watchdog seeks to rein in prevailing monopolistic and anti-competitive behaviour within the technology sector**
- **While Alibaba seems to bear the brunt of an increasingly tight regulatory environment, the firm exhibits credit strength as supported by the NUS-CRI 1-year PD and Forward PD**

In light of China's increasingly strict regulatory climate, this week's credit brief is going to focus on a major player within the Chinese internet sub-industry[1] – Alibaba. Along with the delay of Ant Group's[2] Initial Public Offering (IPO), recent events beget an evaluation of the existing and future credit profile of Alibaba. Despite Alibaba bearing the brunt of Beijing's regulatory clampdown, NUS-CRI's 1-year Probability of Default (1-year PD) and its corresponding Forward 1-year Probability of Default (Forward PD[3]) attest to Alibaba's relatively robust credit position. This can be accredited to the firm's fiscal discipline, diverse sources of revenue and high profitability.

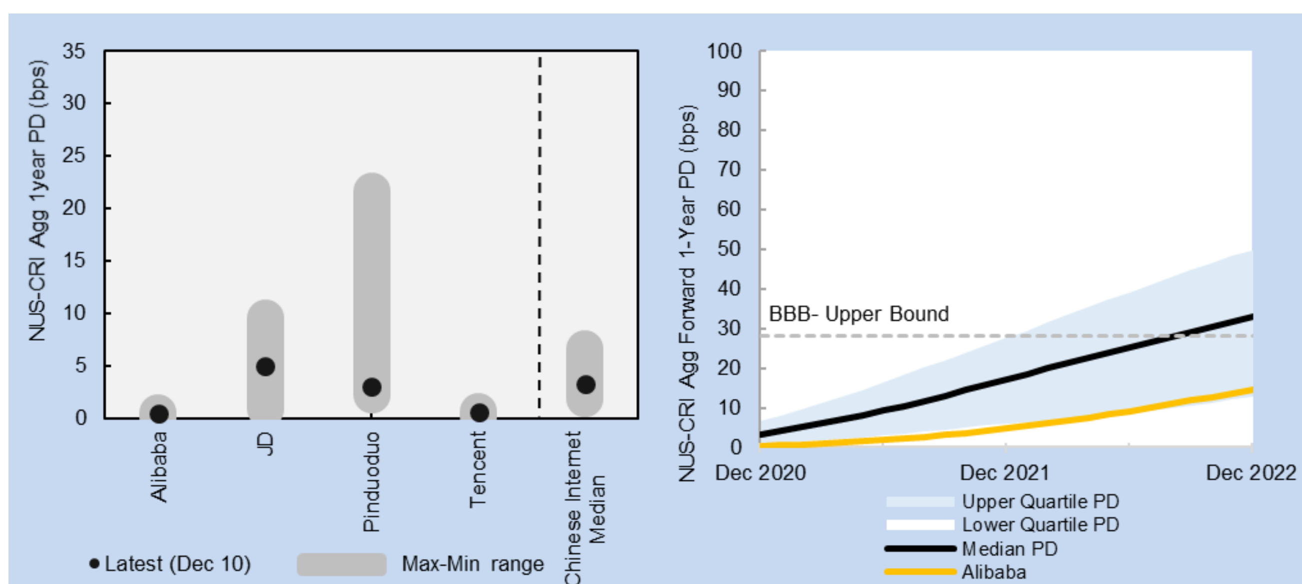

Figure 1a (LHS): NUS-CRI 1-year PD of Alibaba, its peers and Chinese domiciled internet corporates from Dec 2019 to Dec 2020. Figure 2b (RHS): Corresponding NUS-CRI Agg Forward 1-Year based on data feed as Dec 2020 with reference to the PDiR2.0. *Source: NUS-CRI*

As China's central government pushes for an "Internet-Plus" economy, there has been a steady integration of new technologies with traditional industries. Given the unprecedented growth that the Chinese economy has enjoyed over the past decade, demand for financial services remains unmet. As such, given the internet giants' wide online outreach and the technology industry's relatively looser regulatory standards, firms, such as Alibaba, are well-positioned to compete with their counterparts in traditional finance. Taking advantage of the initial regulatory arbitrage, these Chinese internet powerhouses have launched multiple ventures such as JD Finance,

[1] The corporates within the Kraneshare CSI China Internet ETF (KWEB).

[2] Ant group is partially owned by Alibaba.

[3] The Forward PD estimates the credit risk of a company in a future period, which can be interpreted similar 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 1 year plus 6 months, conditional on the firm's survival in the next 6 months.

WeBank and Dealing Matrix. This extension of the already widespread network effect into the financial industry served as yet another catalyst for regulatory watchdogs to intervene.

Beijing has been reining in anti-competitive tactics such as collusion, predatory pricing and excessive subsidizing of low cost services. For instance, Alibaba's cash holding of over USD 60bn can be a barrier to entry for any new competitor. When Alibaba rolled out its cloud computing business, the firm made its adoption and maintenance costs relatively low to acquire market share. Alibaba had the financial bandwidth to withstand an initial history of losses in its cloud venture as it was well-cushioned by profits from its bread and butter e-commerce franchise. The strategy proved worthwhile as Alibaba's cloud computing business growth outpaced that of its US competitors – Amazon and Microsoft. The proposed regulatory measures include a halt on the use of sensitive consumer data for targeted advertising which could potentially hurt Alibaba's e-commerce sales. Moreover, the rising anti-monopoly scrutiny led to a regulatory review of Alibaba's past deals. In reaction to Alibaba's failure to declare and seek approval, the regulators have implemented a fine on the firm. While the fine is immaterial to Alibaba's incumbent financial position, the firm's ability to make acquisitions and expand is likely to be constrained moving forward.

Nevertheless, as evident in Figure 1a, Alibaba has a lower 1-year PD and a tighter max-min range relative to both the industry median and most of its peers. Similarly, Figure 1b indicates that Alibaba's Forward PD trends along the industry's lower quartile. It also reveals a 2-year term structure that is well within the investment grade threshold of BBB- as proxied by the NUS-CRI's Probability of Default implied Rating 2.0 (PDiR2.0[4]).

	Return on Assets (%)	Current Ratio	Total Debt to EBITDA
Alibaba	10.17	1.91	0.93
Tencent	11.94	1.06	1.44
Pinduoduo	NA	1.60	NA
JD.com	9.26	0.99	1.52
Chinese Internet corporates	4.75	2.74	1.63

Table 1: Financial ratios for Alibaba, its peers and the Chinese domiciled internet corporates *Source: Bloomberg*

Generally, the asset-light technology sector has low leverage. Alibaba has a rather conservative capital structure. From a liquidity standpoint, the firm is well-positioned with a current ratio of 1.91, enjoying strong cash flow buffers. This can be accredited to its history of robust FCF generation. Alibaba's ecosystem is well-balanced across both B2B and B2C domains, leading multiple markets including e-commerce, payments, logistics and cloud computing. In a new world shaped by the pandemic, e-commerce and digitalization are more important than ever. By the end of Q3 2020, the firm's reported revenues beat analysts' estimates – e-commerce revenue was up by 29% and cloud computing revenue was up by 60%. Moreover, profitability will continue to trend upwards as CAGR is expected to average around 21% for the next 3 years.

The recent news on Alibaba's potential delisting from the US market and delay in the highly anticipated IPO of Ant Group have raised the eyebrows of retail and institutional investors alike. However, the firm can still raise capital via the Hong Kong stock exchange. Despite the momentary delay, Ant group's eventual IPO should add value to Alibaba's overall business. In sum, Alibaba's 1-year and Forward PD continue to run in tandem with its strong credit narrative. While the ongoing speculations on the forthcoming regulatory obstacles might be worrying, Alibaba's credit history and performance provide comfort to investors. In the short run, the impending regulations are potential setbacks to the overall business. Nevertheless, it seems to be a necessary and painful step for Beijing to better grow and legitimise China as a digital powerhouse.

[4] 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.

Credit News

Company defaults rise in China and US as global figure doubles

Dec 13. Global corporate default rates have surged to double that of last year as a result of the pandemic. China is at the forefront of this, with over USD 30.5bn in loans canceled or postponed. Yields for Chinese investment-grade issuances have steadily risen over the year, as investors' price in the increased in default risks. Globally, the overall default rate has reached its highest in almost a decade. Around 60 percent of global defaults being concentrated within 4 sectors, which include energy and consumer goods. Going forward, affected companies will likely see less aggressive support from governments and central banks. (Nikkei Asia)

UK high street insolvencies ricochet to direct lenders

Dec 11. Private loan investors are facing difficulties as the coronavirus pandemic has led to several UK companies going insolvent. While the UK central bank has been successful in assisting larger companies, smaller private enterprises are unable to reap these benefits. Alcentra, KKR and Pemberton are some lenders that have been hit particularly hard, as their investments in the F&B and travel sectors have failed to perform in the wake of mandatory lockdowns. Private credit firms have held back from giving loans to new companies and are now attempting to help their existing borrowers to tide through the pandemic. Firms have considered alternatives to recover their initial investments, such as Debt-for-Equity swaps, but these measures may still not enable them to recoup their original investments. (FT)

Corporate America's borrowing binge may be ending

Dec 10. With USD 1.1tn in investment-grade bonds planned to be issued next year, a cool-off is expected in the corporate debt market. This expected year-on-year fall of over 32% will arise as companies look to pay down the debt they amassed as a buffer for the pandemic. Investors are now feeling the burn from over-demand of fixed income securities, as they face yields hovering below expected levels of inflation, implying negative real returns. However, positive sentiments related to a strong vaccine distribution program may spur companies to pursue debt-financed M&A activity in the near future. Corporates might take advantage of this low interest rate environment as well, with increased refinancing and new borrowings. (WSJ)

Chinese state investors sound alarm on cash crunch after defaults

Dec 10. Local government finance vehicles are now facing a liquidity crisis, as credit pools have dried up following a series of high-profile defaults by State-Owned Enterprises (SOEs). The entities have spent over CNY 3.4tn in project financing as of October 2020, but then saw a 14% drop in issuances year-on-year afterward. LGFVs now struggle to refinance their loans, as investors are now uncertain as to whether Chinese regulators would assist distressed SOEs in the future. This caused financing costs to rise, from 4 percent in the months up to September, to 4.8% afterward. China's economy could be hurt by this, as LGFVs can finance projects and create jobs without needing governments in the area to overcome statutory debt limits themselves. Without easily available credit, future state projects could be halted. (FT)

Investors see lower risk of default by US airlines

Dec 8. Credit Default Swaps (CDS) for debt issued by US airlines have seen a significant drop in premiums, reaching levels seen at the start of the pandemic. As airlines receive a lifeline from the government to help them stave through until next year, investors are more positive on the outlook of the industry. This was closely followed by the rally in share prices of the largest airlines in the US, which have outperformed market indexes after vaccine test results were made public over a month ago. Airlines will continue to receive help from the government in the near future as they attempt to raise capital from public investors. This will give the badly hit industry a chance to weather the rapid cash burn caused by the pandemic. (FT)

Bulgarian banks extend loan repayment moratorium (Reuters)

NTT's record bond issue to wrap up bumper year for Japan corporate bond market (Reuters)

Chinese chip maker in default on USD 2.5bn of dollar bonds (WSJ)

Regulatory Updates

UK ministers plan new state-backed loan scheme for SMEs

Dec 14. The UK government plans to launch a new government-backed guarantee to permanently replace the GBP 65bn Covid loan program to support banks in providing loans to a wide range of small and medium enterprises. The new loan scheme could carry a guarantee of up to 80 percent for loans of up to GBP 10mn for businesses that are deemed viable but unable to obtain finance from their lender. Banks will be allowed to set interest rates for new loans, although the interest rate is likely to be limited to around 15 percent. The rules of the new plan will be more in line with the existing Coronavirus Business Interruption Loan Scheme (CBILS), which provided approximately GBP 18.5 billion in loans to large SMEs during the pandemic. This, in turn, would mean stricter checks on the creditworthiness of borrowers. One of the more controversial factors will be the possibility of restoring some personal guarantees in loans. As the terms of the scheme have yet been finalized, the Treasury can extend the existing loan schemes to ensure that businesses have access to finance after the UK leaves the EU single market. (FT)

Fed poised to extend crisis bond-buying programme

Dec 13. The Federal Reserve (Fed) is expected to continue purchasing USD 120bn of debt per month until the recovery meets certain conditions. Should this occur, it would cement the Fed's easing position and would keep interest rates close to zero until inflation is on track to reach 2% and the economy reaches full employment. With COVID-19 cases rising and the uncertainty arising from congress surrounding fiscal stimulus, the Fed may have to act now to support the economy. If the Fed decides to take more aggressive monetary policy steps, it is more like to increase the maturity of its debt purchases. On the other hand, some investors believe that the Fed should hold off from strong policy movements given the already easing nature of financial conditions to pre-pandemic levels. The less action witnessed on the fiscal front, the more likely the Fed will adjust monetary policy. (FT)

China pledges better supervision of bond credit rating industry (Bloomberg)

ECB expands and extends its bond buying as coronavirus weighs on the recovery (CNBC)

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