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Weekly Credit Brief Nov 23 - Nov 29 2021

Curbed expansion and top-up share placement may be a silver lining for Haidilao's worsened credit profile

by Wang Anyi

- **The NUS-CRI 1-year PD indicates Haidilao's increasingly elevated credit risk compared to its peer Jiumaojiu, with the operational headwinds and higher leverage driven by aggressive expansion in the past**
- **Nevertheless, Haidilao's plan to curb expansion and issuance of new shares may help bolster its financial health in the future despite one-off costs, as displayed by NUS-CRI 1-year Forward PD**

Haidilao International Holdings Co (Haidilao), a restaurant chain that became popular in recent years, is at the forefront of China's retail-restaurants industry. On Nov 5, Haidilao announced that it will suspend or close 300 outlets, casting a spotlight on its worsening financial health and operations after a period of aggressive expansion over the past two years[1]. High capital expenditures in the past, coupled with lackluster consumer demand due in part to the COVID-19 pandemic, eventually burdened it with negative cash flows, eroded the company's liquidity, and drove up its leverage. The NUS-CRI 1-year Probability of Default (PD) in Figure 1a demonstrates the worsened credit profile of Haidilao since the beginning of this year, as the company's credit risk increased from well below A- Upper Bound to levels near BB+ Upper Bound when referenced to PDiR2.0[2] bounds. In comparison, its peer[3] Jiumaojiu International Holdings Ltd (Jiumaojiu) demonstrated much lower credit risk, on the back of better-managed expansion and robust growth. As a result of heightened debt pressures, Haidilao also proposed a top-up share placement plan to raise capital to support its deleveraging efforts. Concurrent with the newly announced plan to curb expansion which may boost cash flow, Haidilao's credit risk outlook is set to improve as displayed by the NUS-CRI Forward 1-year PD (Forward PD[4]) in Figure 1b.

[1] Haidilao opened 308 new stores in 2019 and initially planned to launch 300 new stores in 2020. However, the management saw COVID-19 as an opportunity to expand as other restaurants shut down.
[2] 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.
[3] Haidilao and Jiumaojiu are the two leading Chinese-style restaurant chains domiciled in China and listed on the Hong Kong stock exchange.
[4] 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 18 months, conditional on the firm's survival in the next 6 months.

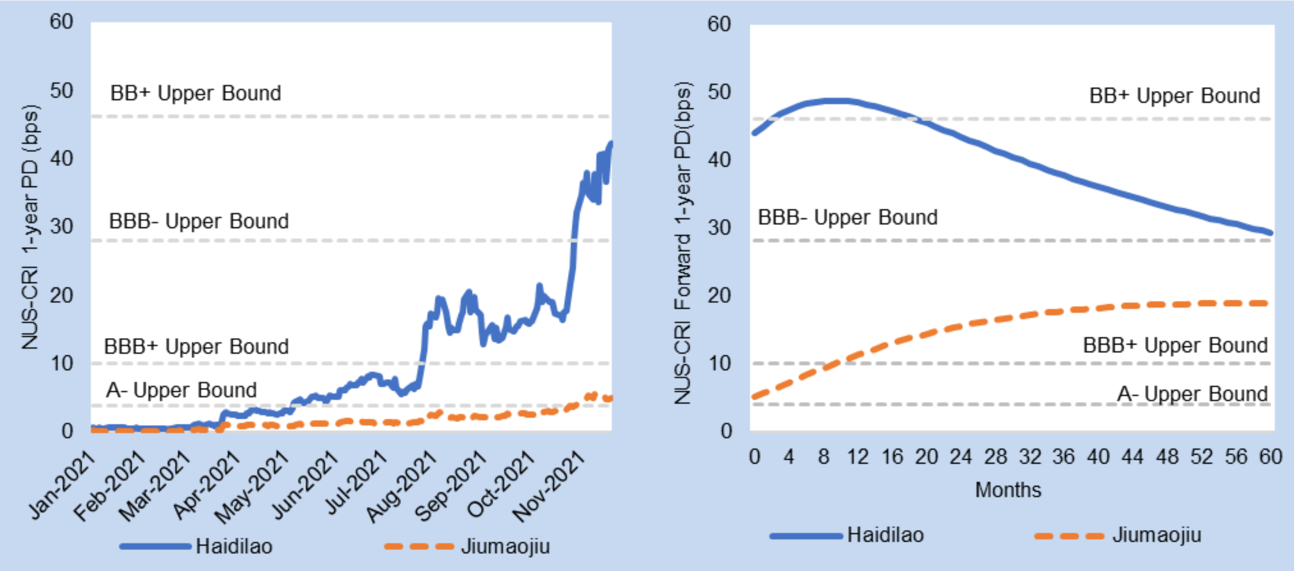

Figure 1a (LHS): NUS-CRI 1-year PD for Haidilao and Jiumaojiu from Jan-2021 to Nov-2021 with reference to PDiR2.0 bounds. Figure 1b (RHS): NUS-CRI Forward 1-year PD for Haidilao and Jiumaojiu as of Nov-2021 with reference to PDiR2.0 bounds. *Source: NUS-CRI*

Haidilao embarked on an aggressive expansion drive in early 2020 that doubled its outlets to nearly 1600 globally. The radical expansion brought about high capital expenditures and burdened the company's free cash flows (Figure 2a). Even worse, its stores showed poor performance and lower productivity, due in part to dining constraints and a slump in consumer spending due to the pandemic. Haidilao's table turnover rate continued dropping from 4.8 in 2019, to 3.5 in 2020 and 3.0 in H1 2021. Moreover, revenues failed to catch up with the climbing costs, among which fixed costs including rents and staff costs were the main contributors[5]. While Haidilao's expansion was mistimed and mismanaged, Jiumaojiu's expansion plan was better managed over the same period, which resulted in relatively lower capital expenditures to sales and higher free cash flow margin (Figure 2a). Moreover, Jiumaojiu demonstrated robust post-pandemic growth and returned to profitability in H1 2021, with strong growth momentum. The improved operations of Jiumaojiu can be seen from its higher profit margins, which stand at 9.20% in H1 2021, far above Haidilao's 0.47% which is down from 6.72% in H2 2020 (Figure 3b).

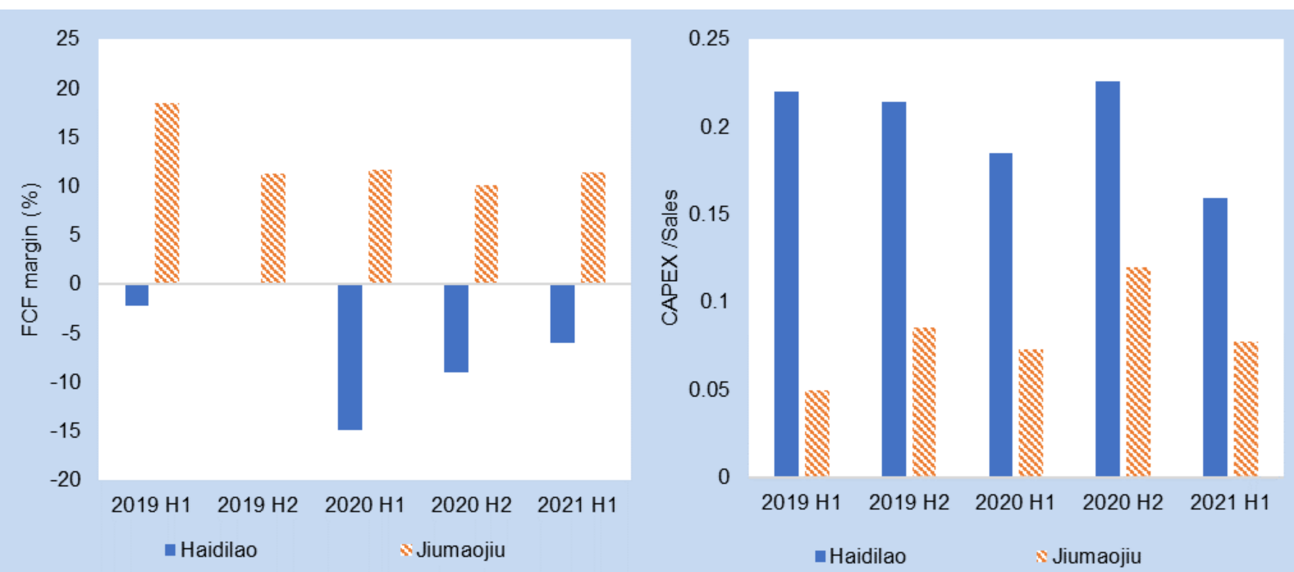

Figure 2a (LHS): Free Cash Flows (FCF) margin (%) of Haidilao and Jiumaojiu from H1 2019 to H1 2021. Figure 2b (RHS): Capital Expenditures (CAPEX) / Sales of Haidilao and Jiumaojiu from H1 2019 to H1 2021. *Source: Bloomberg*

To support its rapid expansion and resultant expenses, Haidilao has taken on more debt and thus faces heightened financing pressures. It secured a CNY 2.1bn loan to withstand the pandemic. In Jan-2021, it issued a dollar bond totaling USD 600mn. As such, Haidilao has amassed leverage, with total debt to equity increasing from 51% at the end of 2019 to 160% in H1 2021, much higher than 42.73% of Jiumaojiu (Figure 3b). The

[5] The staff cost accounted for 35.6% of its total expenditures in H1 2021 and 33.8% in 2020. In H1 2021, property rentals and related expenses soared by 125.2% on a YoY basis, mainly due to the business expansion.

interest coverage ratio dropped sharply from 8.25 at the end of 2020 to 2.1 in H1 2021, raising serious concerns about its ability to service debt. The YTM in Figure 3a also shows an upward trend since Jan-2021, increasing Haidilao's cost of debt financing as investors show caution in holding the firm's bonds.

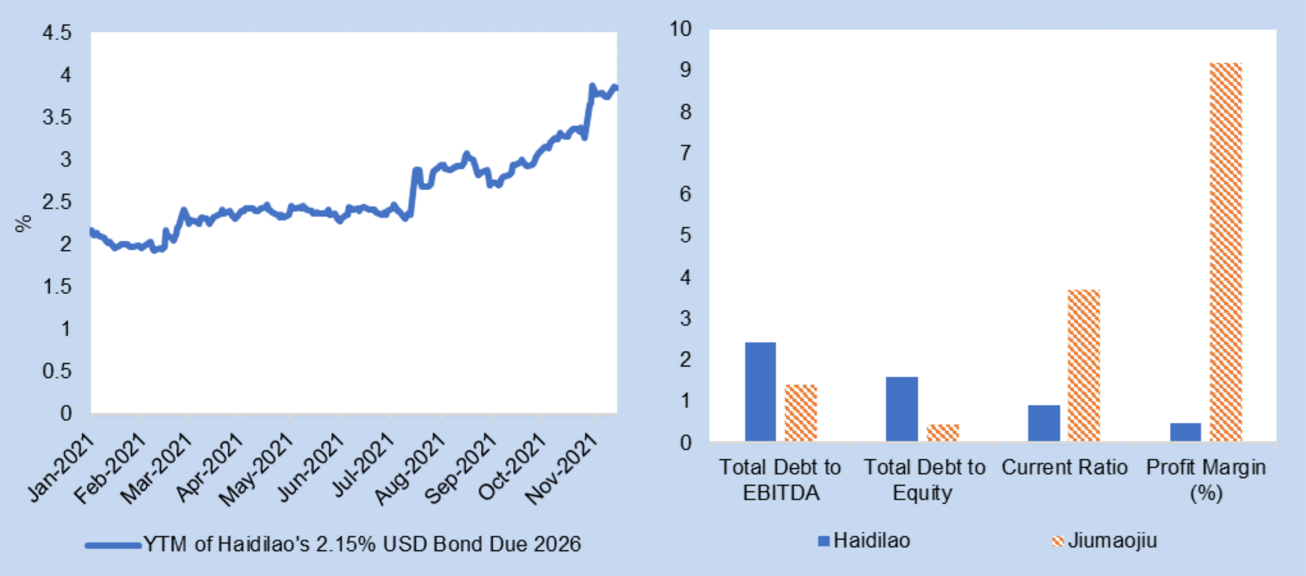

Figure 3a (LHS): YTM of Haidilao's 2.15% USD Bond Due 2026 from Jan-2021 to Nov-2021. Figure 3b (RHS): Total Debt to EBITDA, Total Debt to Equity, Current Ratio, and Profit Margin (%) of Haidilao and Jiumaojiu as of H1 2021. *Source: Bloomberg*

As the firm continues to suffer from cash flow problems, Haidilao finally decided to slow down the pace of expansion. By the end of this year, the company plans to shut down 300 underperforming restaurants with relatively low customer traffic. The company will also launch a plan focused on improving its operations of existing stores and will halt large-scale expansion plans until the table turnover rate recovers to 4.0. In the near term, closing the stores may incur one-off provisions or write-downs for assets or leases in H2 2021. On top of that, as Haidilao's leverage remains high, its credit risk may still experience an uptick in the next few months (Figure 1b). Nevertheless, in the longer term, curbing expansion and improving operating efficiency should aid in reducing costs and boosting the profitability of existing stores, relieving the cash flow pressure currently faced by the company. Investors' sentiment towards plans of curbing expansion also appeared to be positive.

Furthermore, to deleverage, Haidilao raised HKD 2.34bn through a top-up placing of shares on Nov 22. 30% of the capital raised will be used for repayment of credit facilities, while the rest will be directed to enhancing supply chain management and product development, as well as for working capital purposes. The top-up placing of shares may help Haidilao deleverage and shore up its liquidity. This, in tandem with potential stronger cash flows in the future, could contribute to an improved credit outlook for Haidilao as demonstrated by its Forward PD. In comparison, despite Jiumaojiu's robust cash flow generating ability (Figure 2a) and multi-brand strategy could help mitigate some risks in the future, increased investment to support new brands and weakening consumer demand pose potential risks in its credit outlook.

With the emphasis on improving the operations of existing stores, the success of Haidilao's deleveraging process will depend on its ability to generate future cash flows and its popularity among customers. However, as China's economic recovery stalls, the restaurant industry still has a long way to return to pre-pandemic levels as consumer demand is still weaker than expected. As scattered COVID-19 outbreaks, as well as the fallout of the new COVID-19 Omicron variant, discourage consumers from dining out, the lingering effect of the pandemic may hinder retail restaurants' recovery. Moving forward, Haidilao, as well as Jiumaojiu, will need to ensure financial discipline in expansion, especially in the face of an increasingly complex post-pandemic economy.

Credit News

China property turmoil risks upending green debt market

Nov 26. China's green real estate bond sales were booming, accounting for about 47% of China's environmentally-focused offshore debt, until Evergrande-led contagion caused financial distress to China's real estate industry. Recently, many prominent property firms are struggling to meet debt obligations, and the contagion of debt distress also threatens the green bond market. Projects funded by green bonds are in doubt now as developers who issued these bonds may have exaggerated their sustainability-linked credentials. Meanwhile, the dramatic sell-off in China's offshore junk bonds caused by such doubt has driven up their yields and dragged down prices, which in turn triggered the average prices for green property debt sold offshore to drop drastically. The resultant prohibitively high borrowing costs make many developers unable to access the offshore credit market to refinance dollar debt and face the resultant liquidity crisis. (Bloomberg)

High-Yield bond sales soar to record as investors have few other places to go

Nov 26. Investors' hunt for higher fixed-income returns has driven sales of low-rated corporate bonds to a record. US companies have sold more than USD 455bn of bonds with speculative-grade credit ratings this year through Monday, beating the full-year total for 2020. The broader leveraged finance market, which also includes leveraged loans, has sold more than USD 1tn in bonds and loans this year, also a record. Junk bonds and leveraged loans are typically issued by companies with significant leverage, making them more sensitive to the economy's trajectory. Some market watchers worry that investors are taking on too much risk and that companies are piling up too much debt. However, analysts and investors expect the record pace of junk-bond sales to moderate heading into 2022, as many companies have raised sizable cash stockpiles and refinanced debt over the past two years. Higher inflation could also make junk bonds less appealing. (WSJ)

The Evergrande blueprint worked for other Chinese developers, until it didn't

Nov 28. China's housing boom has generated a slew of developers that have taken on significant debt to support rapid expansion. As credit becomes limited and new property sales fall, they are already inflicting huge losses on international investors. While Evergrande has managed to scrape up finances to make last-minute bond payments so far, at least four developers have defaulted on their dollar bonds since early October. If the market for new bond sales does not reopen soon, the number of casualties could rise, as large obligations are due early next year. At the end of October, the average yield on Chinese property developers' US dollar junk notes in a larger ICE BofA index was nearly 30%. (WSJ)

Bank of England starts policing unruly world of ESG debt

Nov 24. The Bank of England (BOE) will start buying bonds that meet its ESG standards and grading bonds by metrics that include their issuers' emission intensity. Along with the scorecards, the BOE will also release the list of issuers whose bonds the bank holds, which could be a template for investors looking to make their portfolio more environmentally friendly. The European Central Bank is projected to start considering ESG metrics in its USD 346bn corporate bond purchases next year. The actions from the central banks are hoped to set a precedent for the market because although USD 13tn corporate bonds are outstanding, there is still a lack of standardization on how to grade securities based on ESG metrics. (Bloomberg)

Shorter-tenor Indian bonds to bear brunt of hawkish RBI bets

Nov 29. Bonds of shorter maturities may record further declines as signs of economic recovery increase expectations of policy normalization by RBI. The yield on bonds with maturities of up to 2 years has registered an increase as the RBI reduces excess liquidity from the banking system. In comparison, bonds with longer-term maturities have registered a smaller increase in rates. Money market rates and yields on short-term debt are also expected to increase further on the back of expectations of a possible hike in the reverse repo rate. Short maturity bonds are more sensitive to central bank operations aimed at the reduction of liquidity. On the other hand, longer maturity bonds benefit from expectations of faster economic growth. (Bloomberg)

Chinese property developer Kaisa proposes USD 400mn debt swap (Mint)

China's developers face USD 1.3bn in December bond payments (Bloomberg)

PBOC official says china to maintain ample liquidity (Bloomberg)

Regulatory Updates

Covid-19 variant upends investor bets on rate increases

Nov 26. Investors piled into government bonds and quickly recalibrated their expectations for interest-rate increases in response to the new Covid-19 Omicron variant. The yield on the 10-year US Treasury note dropped to 1.484% on Friday, from 1.644% at Wednesday's close. That marks the largest trading-session decline since March 2020, at the start of the pandemic. Federal-funds futures, a proxy for market expectations of interest-rate changes, shifted downward Friday, with the market anticipating that the Federal Reserve will keep interest rates low for longer. With fears that a new spate of restrictions to slow the spread of the variant will set back global growth prospects, the majority of investors are now pricing in two or three quarter-percentage-point rate increases by the end of 2022, compared with three or four on Wednesday. (WSJ)

Regulators to probe if EU banks played down loan-loss provisions

Nov 24. Under 'collective assessment' of the new accounting standards, entire groups of borrowers may be moved into a category with higher loan-loss charges. Evidence shows that EU domiciled banks may be reluctant to use such collective assessment; for example, as of June 2020, just over a third of banks used the 'collective assessment' measure. Moving an entire portfolio to stage 2 leads to a high impact on expected losses. It may also be difficult for banks to measure the full impact of losses related to Covid-19 and calculate final provisions before the crisis comes to an end and support measures are withdrawn. However, the lack of collective assessment does not seem to be justified and will be an important area of further scrutiny for regulatory supervisors. European regulators will examine whether lenders downplayed the potential cost of bad loans during the pandemic. (FT)

ECB doesn't need to intervene on inflation for now, Panetta says (Bloomberg)

Fed's Bostic plays down risk from new variant, is open to faster taper (Bloomberg)

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