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The credit profile of the global e-commerce discretionary industry deteriorates post-pandemic

by Wang Chenye

- **NUS-CRI Agg PD for the global e-commerce discretionary companies increased post-pandemic, with the US-domiciled firms recently seeing a worsening in their credit profile**
- **NUS-CRI Forward PD for the US-based e-commerce discretionary companies deteriorates more than the global median potentially due to their heightened debt servicing pressures**

After a robust growth phase brought on by the COVID-19 pandemic, e-commerce discretionary brands now grapple with a shrinking customer base and a challenging financial landscape post-pandemic due in part to the tightening of credit conditions. The NUS-CRI Aggregate (median) 1-year Probability of Default (Agg PD) for the global e-commerce discretionary companies remained low during the pandemic but deteriorated to a non-investment grade in 2022. It has since hovered around BBB- upper bound when referenced to PDiR2.0 bounds[1] (See Figure 1a). The US-domiciled e-commerce companies witnessed volatile business cycles in particular, with many e-commerce startups going public in 2020 and 2021 and then facing severe financial problems in 2022. The Agg PD for US e-commerce discretionary firms, initially below the global median, peaked in 2022 due to falling online spending, continuous interest rate hikes and a resultant decline in market capitalizations. Although the Agg PD improved from the second half of 2022 with the exits of weaker performers in the industry and some companies undertaking cost controls, it faced a setback after a series of US banks collapsed in 2023. The persistent high-interest rate, along with capital withdrawal driven by the tightening credit conditions, has been plaguing the indebted and cash-burning US-domiciled e-commerce companies. The NUS-CRI Aggregate (median) Forward 1-year Probability of Default (Forward PD[2]) in Figure 1b shows a clear deterioration in the credit risk profile of the industry, suggesting heightened financial distress over the coming year.

[1] The Probability of Default implied Rating version 2.0 (PDiR2.0) provides a more familiar interpretation by 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 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.

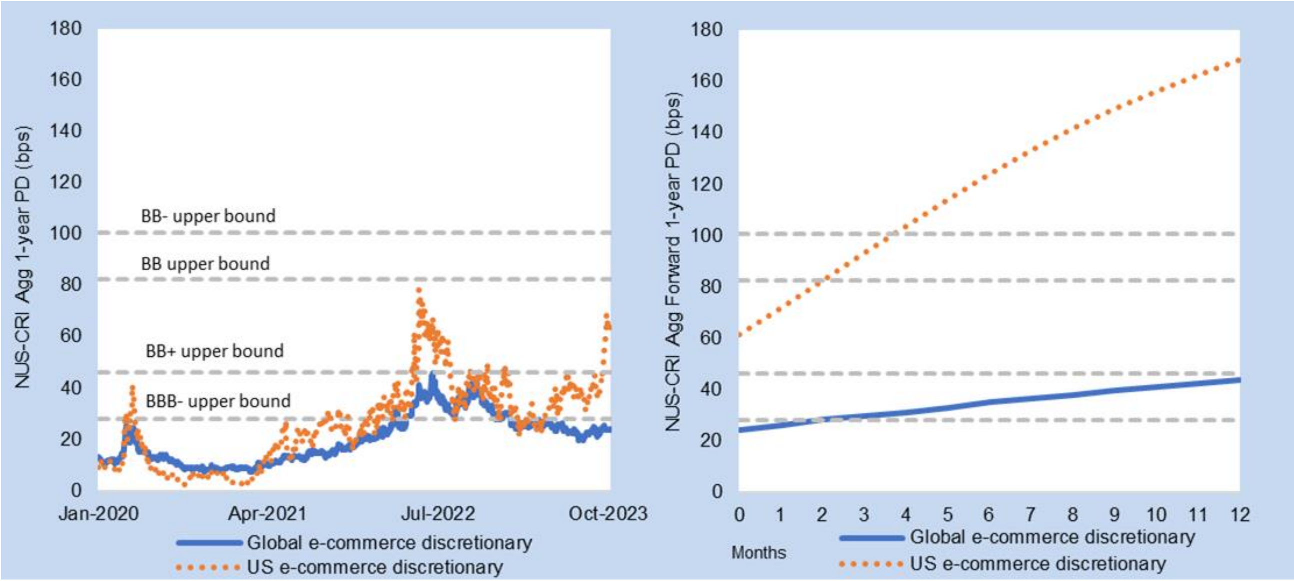

Figure 1a (LHS): NUS-CRI Agg (median) 1-year PD for global e-commerce discretionary companies and US-domiciled e-commerce discretionary companies from Jan-2020 to Oct-2023, with reference to PDiR2.0 bounds; Figure 1b (RHS): NUS-CRI Agg (median) Forward 1-year PD for global e-commerce discretionary companies and US domiciled e-commerce discretionary companies as of Oct-2023, with reference to PDiR2.0 bounds. *Source: NUS-CRI*

E-commerce companies have demonstrated substantial growth (See Figure 2a) during the pandemic while the offline retail segment faced severe challenges with many brick-and-mortar stores having to shut down due to unmarketable inventory, high rental burdens, and personnel expenses. Concurrently, the economic stimulus measures and a low-interest-rate macroeconomic environment reduced borrowing costs for e-commerce companies. Especially in the US, the world's second-biggest e-commerce market, the infusion of venture capital into industry startups facilitated a concentration of IPOs during the pandemic[3]. Capitalizing on equity inflows and access to cheap credit, e-commerce companies expanded their balance sheets. Although the surge in online sales contributed to buoying the industry's revenue-generating capabilities, it still fell short of fully compensating for the industry's cash-intensive and loss-prone nature. As indicated in Table 1, only in 2020 and 2021 did the median annual net profit margin for US-domiciled e-commerce discretionary companies barely turn positive, while the industry median interest coverage ratio remained negative, suggestive of repayment pressures that have contributed to the industry's worsening credit profile.

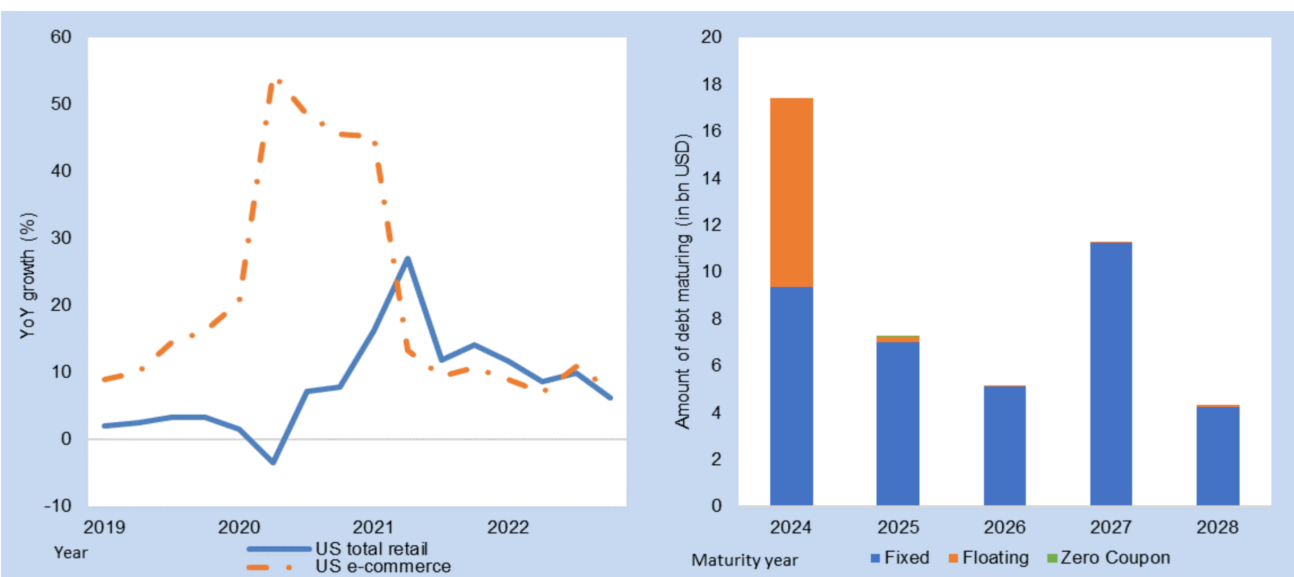

Figure 2a (LHS): Quarterly YoY growth of total retail sales and e-commerce sales in the US; Figure 2b (RHS): Debt maturity distribution of the US e-commerce discretionary companies. *Source: US Census Bureau; Bloomberg*

[3] 23.4% of the US domiciled e-commerce discretionary companies in the sample went public in 2021 such as Allbrids, a.k.a. Brands, Figs and Poshmark.

Year	2020	2021	2022	Q1-2023	Q2-2023
Interest Coverage Ratio	-2.9x	-0.2x	-9.2x	-4.7x	-3.2x
Sales & Marketing Expense to Revenue	19.8%	19.6%	18.8%	16.3%	18.6%
Net Profit Margin	0.2%	1.0%	-4.6%	-7.4%	-5.6%

Table 1: Quarterly median of interest coverage ratio, sales & marketing expense ratio and net profit margin for US-domiciled discretionary companies. *Source: Bloomberg*

However, consumer behaviors underwent a shift with the gradual resurgence of offline retail in the changed post-pandemic environment. Despite the swift establishment of platform ecosystems, e-commerce companies struggle to maintain long-term momentum (See Figure 2a) and struggle to create genuinely distinctive products to serve as a brand stronghold. Numerous e-commerce Direct-To-Customers (DTC)[4] brands find themselves caught in a vicious cycle where growth relies heavily on paid marketing, leading to a state of stagnation. As seen in Table 1, over the past three years, sales and marketing expenses for US e-commerce discretionary brands have consistently cost close to 20% of revenue. Moreover, since the second half of 2022, major central banks worldwide have initiated the process of raising interest rates, continuously driving up borrowing costs and increasing the debt service burden for companies. Meanwhile, a series of underperforming companies has made investors and lenders cautious towards the industry's ability to maintain their bottom lines, adding hurdles for e-commerce players to secure financing. Finally, due to limited customer engagement, high expenses, and financing hurdles, these companies face a sharp deterioration in both cash flows and profitability, as evidenced by a worsening interest coverage ratio and net profit margin since 2022 (See Table 1).

In comparison to their global counterparts, e-commerce discretionary companies domiciled in the US are facing heightened and immediate pressure to settle their debts, as shown in Figure 2b. Additionally, nearly half of the debt maturing in 2024 is of the floating-rate variety, implying that these companies have been incurring higher interest payments, a cost that could escalate further if the US Federal Reserve continues its rate hikes. With the gradual withdrawal of financing channels such as venture capital in conjunction with the tightened lending standards of banks, e-commerce companies in the US are faced with a depletion of cash reserves, limited financing channels, and higher financing costs. These challenges are poised to exacerbate the credit profile of e-commerce discretionary companies domiciled in the US, as evident from the elevated Forward PD and its widening gap from the global median.

[4] Direct-to-consumer (DTC) is a retail model where brands sell directly to new customers. It skips the wholesale middlemen and eliminates the need to join forces with big retail brands and brick-and-mortar stores.

Credit News

Rising interest rates curb lending growth for big US banks

Oct 09. The big US banks, including JPMorgan Chase, Bank of America, and Citigroup, face a potential hit to their profits as lending growth slows. Net interest income, which has boosted earnings over the past 18 months, is at risk. While they benefited from charging more for loans with the Federal Reserve raising benchmark rates, corporate borrowing has declined recently due to rising rates. Analysts attribute this slowdown to higher rates. Additionally, banks have become more cautious about their lending practices in anticipation of stricter regulations like Basel III Endgame, which would require more loss-absorbing capital. Pressure to offer higher savings rates to retain deposits is also squeezing profits, as deposit levels have decreased since the Fed raised interest rates. (FT)

Euro high-yield bonds flirt with end of longest win streak since 2021

Oct 05. The longest winning streak for euro high-yield corporate bonds since 2021 is facing a threat due to mounting issues among Europe's riskiest borrowers. Over the past six months, euro-denominated speculative-grade debt has shown positive returns, but these gains have been steadily decreasing, resulting in a 0.6% loss this month. This could mark the asset class's first monthly loss since March when Credit Suisse's collapse disrupted global markets. Recent volatility in global markets, including a spike in the credit risk gauge for European junk firms and rising yields on 30-year US Treasuries, has contributed to the decline. Additionally, expectations of increased defaults in the future, particularly as riskier debt needs refinancing, have affected global high-grade corporate bonds, despite current low default rates. (Bloomberg)

Japan seeks to resurrect junk bond market

Oct 06. Japan is actively working to revitalize its stagnant junk bond market, aiming to reduce corporate reliance on bank loans as domestic dealmaking is expected to surge. Government officials and regulators are seeking input from bank leaders, M&A advisors, and private equity executives to stimulate interest in higher-yield debt. This initiative aligns with increased international investor interest in Japan, following years of caution due to slow economic growth and limited shareholder focus. Prominent figures like BlackRock's Larry Fink are meeting with Japanese officials and company leaders to advocate for more investment. A thriving high-yield market could facilitate leveraged buyouts and offer profitable opportunities to cash-rich lenders, as Japan has seen minimal junk bond issuance for two decades due to heavy reliance on major banks like Mizuho, MUFG, and SMFG. (FT)

Big-company bankruptcies hang over economy

Oct 08. Several major corporations, including SVB Financial, Bed Bath & Beyond, and Yellow, have sought chapter 11 bankruptcy protection this year. They attribute their financial troubles to factors such as elevated inflation, higher interest rates, reduced government assistance, and lingering supply chain disruptions. It's expected that more corporate bankruptcies will follow, driven by the impact of high interest rates on large companies. The number of significant chapter 11 filings has reportedly tripled in the first half of this year compared to the same period last year. These developments coincide with increasing economic risks, including households depleting pandemic savings, reduced bank lending, and surging bond yields, which could hamper overall economic growth. Businesses that accumulated significant debt during a period of low-interest rates are particularly vulnerable as the economy slows while interest rates remain high. (WSJ)

Distressed debt anxiety is spreading across emerging markets

Oct 08. Rising U.S. Treasury yields have revived concerns of an increase in credit risk in emerging markets. Approximately 21 emerging-market nations are grappling with sovereign dollar debt trading at distressing levels, with yields around 1,000 basis points above Treasuries. Ethiopia, with a nearly 50 percentage point yield spread over Treasuries, is among those at high risk, along with Tunisia, Pakistan, Argentina, Bolivia, and Egypt. A strong U.S. dollar and yields nearing 5% are contributing to what's called a "bond shock," eroding optimism for nations with fragile financials. This situation makes it difficult for vulnerable issuers to access primary markets, forcing them into debt restructuring and currency depreciation which further compounds the challenges. (Bloomberg)

US bond funds suffer outflows on rate worries; money market funds gain traction (Reuters)

Surging bond yields add to Canadian homeowners' mortgage pain as renewals loom (Reuters)

Metro Bank board to meet bondholders over refinancing package (FT)

Regulatory Updates

Bank watchdog moves ahead with new ESG rule feared across Europe

Oct 09. The European Banking Authority has urged European banks to embrace the forthcoming ESG rule requiring them to report additional data related to the green asset ratio (GAR). This mandatory disclosure is set to begin in January and will reveal the proportion of a bank's balance sheet aligning with EU-approved sustainable business activities. Despite concerns from banks about potentially low GAR ratios making them appear unfavorable, The EBA stressed the necessity of transparency and action with the financial network. Some banks have already reported preliminary GAR figures, which may be in the single digits due to recurring data challenges. Sustainable investors are concerned about banks' exposure to fossil fuel clients, prompting pension funds to monitor banks' loan portfolios. The EBA is working on guidelines for climate-related stress tests and is considering updates to capital requirements, emphasizing the need for a balanced approach in addressing climate risks without leaving banks undercapitalized or making incorrect penalties based on a green supporting factor. (Bloomberg)

India central bank ups guardrails ahead of global index inflows

Oct 07. India's central bank, the Reserve Bank of India (RBI), has announced plans to use bond sales as a policy tool to manage surplus cash and curb liquidity. This decision comes as India's inclusion in global bond indexes, such as JPMorgan's emerging market gauge, is expected to attract substantial foreign investment, potentially exceeding USD 50bn. The RBI's move aims to absorb excess liquidity and mitigate inflationary pressures resulting from these inflows. The surprise announcement led to a surge in benchmark yields, the most significant increase in over a year. While the RBI's intervention in currency markets has helped stabilize the rupee, the bank is preparing for additional liquidity challenges due to the bond index inclusion. (Bloomberg)

China central bank adds more gold amid elevated local premium (Bloomberg)

NZ central bank holds rates, signals higher hurdle to further hikes; kiwi tumbles (Reuters)

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