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Coinbase Global Ratings Lowered To 'BB-' On Sharply Lower Trading Volumes And Rising Regulatory Risks; Outlook Negative

- Coinbase's trading volumes have weakened meaningfully in the aftermath of the collapse of cryptocurrency exchange FTX (unrated) and regulatory risk is rising, in our view.
- We expect profitability to remain pressured in 2023, despite the recently announced reduction in operating expenses and tailwinds from rising interest rates.
- We lowered our long-term issuer credit rating and senior unsecured debt ratings on Coinbase Global Inc. to 'BB-' from 'BB'.
- The negative outlook reflects continued uncertainties about the depth and duration of the crypto market downturn, insufficient visibility regarding trading volumes following the collapse of FTX, and heightened regulatory risk.

TORONTO (S&P Global Ratings) Jan. 11, 2023--S&P Global Ratings said today it lowered the long-term issuer credit rating and senior unsecured debt ratings on Coinbase Global Inc. to 'BB-' from 'BB'. The outlook is negative.

The downgrade reflects our view that weakened trading volumes in the aftermath of FTX's collapse will continue to pressure Coinbase's profitability. Our 'BB-' issuer credit rating on Coinbase incorporates our expectation of very weak profitability and rising regulatory risks, balanced by a comfortable (although potentially eroding) unrestricted cash cushion over gross debt and low risk profile overall.

We believe FTX's bankruptcy in November has severely hit the crypto industry's perceived credibility, causing a lack of retail engagement. As a result, trading volumes across exchanges, including Coinbase, have declined sharply. We estimate that Coinbase's trading volumes reached a low point in December 2022 and have remained weak so far in January 2023. Coinbase's revenues depend heavily on trading volumes, with transaction revenues representing approximately 80% of total revenues in the first nine months of 2022. Three-quarters of total revenue is from retail transaction revenue.

To counteract headwinds from weakened trading volumes, the company recently announced it was reducing its workforce by approximately 950 employees to lower certain operating expenses by 25% in the first quarter of 2023, compared with the fourth quarter of 2022. With the increase in the federal funds rate to 4.25%-4.5% from zero before March 2022, and additional rate increases expected in the coming months, we expect a sizable uptick in interest income in the fourth quarter of 2022 and full-year 2023. The company earns interest income and corporate interest and other income on customers' fiat balances ($6.6 billion as of Sept. 30), its own corporate cash ($5 billion), and from a revenue-sharing agreement with Circle, the issuer of USDC stablecoin. As part of its agreement with Circle, Coinbase generates income based on the USDC held on its platform and on the amount of USDC minted by Coinbase into the ecosystem (which may or may not be held on its platform). With approximately $44 billion in market capitalization for USDC, USDC's position as a prominent stablecoin provides Coinbase with sizable and growing interest income since rising rates boost revenues on the short-term U.S. Treasuries that back the USDC on a one-to-one basis. Nevertheless, we believe that in the absence of a meaningful uptick in retail engagement, the cost cuts, as well as the tailwinds from rising interest rates, will only partially offset the downdraft in revenues.

Our rating analysis of Coinbase previously acknowledged the higher cyclical variations--peak-to-trough changes in revenue, EBITDA, and EBITDA margin--compared with traditional exchanges that operate in asset classes exhibiting lower volatility. These cyclical variations are reflected in our assessment of the company's business risk, which is weaker than that of most rated traditional exchanges. However, we now believe these cyclical variations exceed what we had previously anticipated, resulting in weaker profitability and credit metrics. We therefore revised our assessment of Coinbase's financial risk by applying an additional volatility adjustment.

Absent a recovery in trading volumes, we expect Coinbase's profitability to remain pressured in 2023. Assuming trading volumes remain at the low level observed in December 2022 and January 2023 so far, we project the company could post very small positive S&P Global adjusted EBITDA in 2023, following the company's guidance of a negative $500 million in 2022, after adding back stock-based compensation. Should trading volumes continue to slump from the already low levels, we anticipate S&P Global adjusted EBITDA to remain solidly in negative territory over the year.

Regulatory risks remain elevated for Coinbase. We believe that the collapse and alleged fraud at FTX, one of the leading crypto exchanges, is likely to accelerate regulatory scrutiny and increase the likelihood of tightened regulation that could affect the business model negatively, at least in the short-term. The New York Department of Financial Services (NYDFS) recently announced a consent order regarding investigation into the company's 2018-2019 compliance program and the compliance backlogs related to its growth in 2021. As part of the consent order, Coinbase is required to pay a $50 million penalty and invest $50 million in compliance programs over the next two years. The SEC is also investigating the company's staking programs and the classification of certain listed assets. We think tighter regulation could slow revenue growth in the short term, for example, by forcing Coinbase to de-list some products (if the SEC were to qualify them as "securities") or by curtailing the growth of its staking programs. Staking activities,

where users earn rewards by using tokens as collateral to validate transactions and create blocks, accounted for 8% of total revenue in the first nine months of 2022, compared with 2% in the prior year.

Coinbase continues to maintain a low credit risk profile. The company has stated it does not lend out customers' crypto assets to crypto firms without their consent. Despite a series of recent bankruptcy filings by several crypto players (crypto lender Celsius, hedge fund Three Arrows Capital, crypto broker Voyager and, more recently FTX and BlockFi), Coinbase did not incur any losses from its financing activities.

At the end of the third quarter, credit and counterparty risk primarily stemmed from $117 million in loan receivables (principally from retail borrow product), secured by bitcoin (with conservative loan-to-values levels), and $168 million of cash deposits at third-party venues (including crypto venues) to facilitate client trades. The company reportedly had very small exposure to FTX ($15 million), and it did not have any exposure to FTT (FTX's proprietary token) or Alameda Research, the market-making arm of FTX. We view Coinbase's credit risk exposures (and vulnerability to more defaults in the sector) as lower than peers in the crypto space.

We expect the pace of cash burn to decelerate in 2023. The company burnt an outstanding $1.8 billion of USD resources (includes cash, USDC, and custodial account overfunding) in the first three quarters of 2022. Following the company's announcement to reduce operating expenses and support from higher rates, we expect lower cash burn this year compared with 2022. If trading volumes were to stabilize or rebound, we believe the company could start reconstituting cash reserves later this year. We estimate in our base-case scenario that the company will continue to operate with excess cash over the about $3.5 billion of S&P Global Ratings-adjusted gross debt (with S&P Global Ratings adjusted leverage of 0.0x) over our 12-month outlook. However, a further decline in trading volumes from the already low December and January levels could accelerate the pace of cash burn resulting in unrestricted cash falling below S&P Global adjusted gross debt, potentially weighing on our financial risk assessment.

The negative outlook indicates continued uncertainties about the depth and duration of the crypto market downturn, insufficient visibility around the path of trading volumes following the collapse of FTX, and heightened regulatory risk.

We could lower the ratings by at least one notch over the next 12 months if:

- Cash burn in the coming quarters materially exceeds our base-case expectations, for example, because trading volumes remain more depressed than we expect in response to materially worse industry conditions;
- Increased regulation proves disruptive for the company's business model; or
- The credit risk profile were to weaken vis-à-vis similarly rated peers, contrary to our current expectations.

We could revise the outlook to stable if we were to see signs of a sustained improvement in trading volumes on Coinbase's platform.

Related Criteria

- General Criteria: Environmental, Social, And Governance Principles In Credit Ratings, Oct. 10, 2021
- General Criteria: Group Rating Methodology, July 1, 2019
- Criteria | Corporates | General: Corporate Methodology: Ratios And Adjustments, April 1, 2019
- Criteria | Corporates | General: Reflecting Subordination Risk In Corporate Issue Ratings, March 28, 2018
- Criteria | Corporates | General: Methodology And Assumptions: Liquidity Descriptors For Global Corporate Issuers, Dec. 16, 2014
- Criteria | Corporates | General: Corporate Methodology, Nov. 19, 2013
- General Criteria: Methodology: Management And Governance Credit Factors For Corporate Entities, Nov. 13, 2012
- General Criteria: Principles Of Credit Ratings, Feb. 16, 2011

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee's assessment of the key rating factors is reflected in the Ratings Score Snapshot above.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria And Research').

Certain terms used in this report, particularly certain adjectives used to express our view on rating relevant factors, have specific meanings ascribed to them in our criteria, and should therefore be read in conjunction with such criteria. Please see Ratings Criteria at www.standardandpoors.com for further information. Complete ratings information is available to subscribers of RatingsDirect at www.capitaliq.com. All ratings affected by this rating action can be found on S&P Global Ratings' public website at www.standardandpoors.com. Use the Ratings search box located in the left column.

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