

Analysis of the Causes of Baolong Real Estate Bond Default

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Abstract: The real estate industry, as a pillar industry of China's national economy, plays an important role in the development of the economy and society. However, in recent years, due to the impact of the epidemic and the tightening of industry regulation, credit risks in the real estate industry have begun to accelerate exposure. Since 2021, there have been frequent defaults on real estate company bonds, and the scale of defaults has rapidly climbed to the top of the industry. Therefore, in-depth analysis of the reasons behind the wave of defaults by real estate companies has become an important issue that urgently needs to be addressed. This article takes Baolong Real Estate as the research object to explore the causes of its bond default. Research has found that: The fundamental reason for the default of Baolong Real Estate bonds lies in the company's operational strategy mistakes and neglect of debt management. The company's heavy holdings in the third and fourth tier real estate markets, coupled with an increase in commercial real estate, have weakened the company's profitability and operational capabilities. In addition, the company's asset liability ratio is too high and there is a problem of mismatched debt maturity. After entering the centralized redemption period, under the dual pressure of tightened external financing environment and hindered internal sales collection, bond defaults ultimately occurred.

Keywords: Real estate enterprises, Bond default, Reasons for breach of contract, Risk analysis.

1. Introduction

Since the second half of 2021, the external financing environment of real estate enterprises has become increasingly severe, and the liquidity crisis of housing enterprises has occurred frequently, which ultimately leads to the concentrated outbreak of credit risks. At present, the default risk of the real estate market is still being released, and the default scale has surpassed that of the manufacturing industry and ranks first in the industry. Therefore, preventing and resolving the default risk of real estate bonds is of great significance to the stability of the bond market and the healthy development of the real estate industry. In the context of the normalization of the bond extension of housing enterprises, although the extension does not constitute a substantial default, it is an important form of credit risk exposure of housing enterprises. For such extended housing enterprises, we must pay high attention to risk to prevent potential risk spread and expansion. This paper chooses Baolong Real Estate as the case study object, aiming to deeply analyze the causes of its bond default, hoping to provide some reference and inspiration for other real estate enterprises to prevent and resolve the bond default risk.

2. Reasons for Bond Default

2.1. Heavy Warehouses in Third - And Fourth Tier Cities with Weak Sales Growth

After the 2008 financial crisis, competitors such as Vanke and Country Garden took advantage of the situation to move north and continuously acquire land in first and second tier cities, pursuing high turnover and high profits. However, Baolong Real Estate began to gradually shift its focus from first and second tier cities to third - and fourth tier cities, avoiding the sharpness of competitors.

From the perspective of land reserves, Baolong Real Estate

began its large-scale layout in third - and fourth tier cities in 2013 and further increased its holdings between 2017 and 2018. After the financial crisis, the overall scale of new land acquisition by Baolong Real Estate was relatively conservative, but in the years after 2013 and 2017, land acquisition was more aggressive. In 2013, Baolong Real Estate added 20.98 million square meters of land reserves, accounting for 76% of the total land reserves in 2012. In terms of urban layout, land reserves involve 20 domestic cities and 1 overseas city, including 10 newly entered cities, of which 9 domestic cities are all second - and third tier cities, reflecting Baolong Real Estate's strategic layout of sinking into second - and third tier cities. In the following three years, Baolong Real Estate's land acquisition policy was relatively conservative. In the two years from 2015 to 2016, we successively entered seven second - and third tier cities, but the scale of land acquisition was relatively small. The scale of land acquisition in the first - and second tier hotspots is also relatively small.

In 2017-2018, Baolong Real Estate launched a new round of aggressive land acquisition, mainly concentrated in third - and fourth tier cities. In 2017, Baolong added 18.11 million square meters of land reserves, mainly distributed in second - and third tier cities, accounting for 84% of the total construction area of the newly added land reserves. Based on the previous round of Baolong's layout in third-and fourth tier cities, by 2017, agreement sales from second - and third tier cities and other cities had accounted for 66% of the total agreement sales. In 2018, Baolong Real Estate adopted a strategy of decentralized sinking to third - and fourth tier cities. At the end of 2018, Baolong's unfinished equity land reserve area was 60.7322 million square meters, of which first-and second tier cities accounted for 4.17% and 37.45% respectively, while third - and fourth tier cities accounted for 58.38%.

However, from the market reaction in this period, after

2013, the regulation was upgraded, and the "New Five Rules" reaffirmed the purchase and loan restrictions, and the house price went from the national general rise to the era of regional differentiation. The increase in housing prices in first tier and hot second tier cities is much higher than that in third - and fourth tier cities, and transactions are in short supply, while transactions in third - and fourth tier cities are dismal. It was not until the second half of 2015, with the promotion of the "monetization of shantytown renovation" policy, that the trading of commercial housing in third - and fourth tier cities began to heat up. But the good times didn't last long. In the second half of 2018, the government began to tighten the "monetization of shantytown renovation" in order to curb the rapid growth of housing prices in third - and fourth tier cities, and transactions in the third - and fourth tier real estate markets quickly cooled down.

Due to Baolong Real Estate's land acquisition pace being exactly opposite to the market, it reduced its layout in first - and second tier cities during the booming real estate market, and instead increased its layout in third - and fourth tier cities. However, its key bet on the third - and fourth tier real estate market was only booming between 2016 and 2018, resulting in a gradual decrease in its sales growth rate. When compared vertically, the overall year-on-year growth rate of Baolong Real Estate's revenue has shown a fluctuating downward trend, especially after the tightening of "shantytown conversion monetization" in 2018 and the cooling of the third - and fourth tier real estate markets, the year-on-year growth rate of revenue has been declining. And 2017-2018 was the stage when Baolong Real Estate further invested in third - and fourth tier cities, reflecting the negative impact of the cooling of the third - and fourth tier real estate market on Baolong Real Estate's revenue. From a horizontal comparison, before 2018, Baolong Real Estate's year-on-year revenue growth rate was slightly higher than the average of the control group in some years, but since then, it has been consistently lower than the average of the control group and the gap between the two has further widened.

The slowdown in the growth rate of Baolong Real Estate's operating revenue has also affected the company's profit level. The net profit margin, return on equity, and total asset return of Baolong Real Estate have all shown a fluctuating downward trend, and since 2018, these profitability indicators have always been lower than the average level of the control group, further indicating that the strategy of heavily investing in third - and fourth tier real estate has weakened Baolong Real Estate's profitability.

In summary, due to Baolong Real Estate's heavy investment in real estate projects in third - and fourth tier cities at the wrong time, it missed the golden development period of the first - and second tier real estate markets, and further invested in low-energy cities on the eve of policy changes and cooling of the third - and fourth tier real estate markets, resulting in slow sales growth and affecting the company's profitability.

2.2. Increase in Commercial Real Estate, Slowing Down Asset Turnover

In 2008, Baolong Real Estate proposed a strategic direction of balancing commercial and residential development, acquiring a large number of commercial plots in Beijing, Tianjin, Chengdu, Chongqing and other places, and developing commercial and residential real estate at the same speed. The commercial property area under construction by

the company in 2008-2009 was nearly 2 million square meters, with a huge amount of accumulated funds. Since 2017, Baolong Real Estate has rapidly expanded in commercial real estate. In 2017, Baolong Real Estate acquired 25 hotels under Wanda Commercial at a cost of 8.306 billion yuan. Before acquiring Wanda Hotels, Baolong only owned 16 international hotels operated and managed by brands such as Hilton, Grand Hyatt, and Hyatt, causing a sensation in the industry. During the same period, Baolong Real Estate acquired commercial real estate projects worth up to 30 billion yuan in the UK, Hainan, and other regions. In 2018, Baolong established a professional commercial operation management company to coordinate and manage its self owned commercial properties. Since Baolong first announced its commercial sector revenue in 2019, the proportion of Baolong's commercial real estate to total revenue has remained at around 20%. Compared with top real estate companies such as Country Garden and Vanke, this proportion is relatively high, while Vanke's proportion is less than 10%. Commercial real estate requires significant upfront investment and a long return cycle. Once there are problems with the funding chain, financial risks can be significant.

Compared to residential real estate, commercial real estate has a longer capital collection cycle and slower recovery speed. The continuous increase in commercial real estate by Baolong Real Estate has dragged down its asset turnover speed. Due to the fact that commercial real estate in real estate enterprises is often accounted for as fixed assets, the efficiency of the enterprise from development to revenue realization can be measured by the fixed asset turnover rate, and the ability of the enterprise to convert accounts receivable into cash can be measured by the accounts receivable turnover rate. As shown in Table 1, when compared vertically, the fixed asset turnover rate of Baolong Real Estate has shown an overall downward trend, especially since 2017 when the decline was significant. This is mainly due to Baolong Real Estate's acquisition of hotels under Wanda in 2017, which greatly increased the scale of commercial assets. The accounts receivable turnover rate has been continuously decreasing since 2017. Horizontally compared with the control group average, Baolong Real Estate's fixed asset turnover rate has always been lower than the industry average, and this gap has further widened since 2017. Meanwhile, the accounts receivable turnover rate has been consistently lower than the control group average since 2017, indicating the negative impact of Baolong Real Estate's investment in commercial real estate on its operational capabilities in 2017.

Table 1. Operating Capacity Indicators of Baolong Real Estate and Control Group (Unit: Times)

particular year	Fixed asset turnover rate	Control group mean	Accounts receivable turnover ratio	Control group mean
2015	5.37	9.47	14.65	9.00
2016	5.39	9.40	15.99	14.21
2017	2.63	17.52	40.24	19.50
2018	2.22	15.72	12.90	20.36
2019	2.60	15.39	13.29	20.73
2020	2.23	16.72	10.79	20.38
2021	1.71	18.51	-20.63	8.68
2022	0.76	17.12	-25.26	-13.28

In the layout of commercial real estate, Baolong's hotel business, which has been continuously focused on, has been

in a loss making state for years, laying the groundwork for its future liquidity crisis. Baolong entered the high-end hotel industry in 2004, but has yet to achieve true profitability. In 2010, the first three Baolong hotels, namely Aloft Grand Hotel, Yiyue Selected Hotel, and Yijun Hotel, opened successively, contributing a total revenue of 183 million yuan that year, accounting for 1.19% of the group's total revenue. Due to the high initial cost investment and long return period of the hotel operation, the net loss of the three hotels in their first year of operation reached 54 million yuan, and the hotel business has been in a loss making state ever since. In 2017, Baolong purchased 25 hotels under Wanda for 8.306 billion yuan. However, this acquisition did not reverse the losses of Baolong Hotel's business. After 2017, the proportion of hotel business to total revenue has significantly increased, but net losses have also been increasing year by year. By 2022, the loss amount has increased from 146 million yuan in 2017 to 2.373 billion yuan.

Overall, due to the large investment amount, long return cycle, and operational difficulties in commercial real estate,

Baolong Real Estate did not achieve corresponding benefits after increasing its investment in commercial real estate. Instead, it led to a slower asset turnover rate and increased the financial burden on the enterprise.

2.3. Excessive Financial Leverage and Mismatched Debt Maturity

According to the trade-off theory, companies can use the "tax shield effect" of debt to increase their value, but as debt grows, the likelihood of the company falling into financial difficulties also increases, even leading to bankruptcy. Both heavy holdings in third - and fourth tier cities and increased investment in commercial real estate require significant financing, while equity financing for real estate companies is limited and therefore mostly debt financing. With the advancement of the strategy, Baolong Real Estate's debt financing scale is increasing, and its debt repayment ability is gradually declining.

Table 2. Debt paying ability indicators of Baolong Real Estate and control group (unit: %)

Particular year	Current ratio	Control Group mean	Quick ratio	Control Group mean	Asset Liability ratio	Control Group mean
2015	1.72	1.95	0.47	0.59	73.21	71.73
2016	2.04	1.85	0.80	0.69	79.31	74.98
2017	1.90	1.66	0.61	0.71	78.23	78.44
2018	1.53	1.67	0.44	0.66	80.92	78.62
2019	1.58	1.52	0.49	0.61	81.33	79.13
2020	1.35	1.58	0.40	0.69	79.19	77.62
2021	1.16	1.41	0.31	0.59	79.21	77.28
2022	1.22	1.32	0.29	0.48	81.85	77.95

As shown in Table 2, when compared vertically, the current ratio and quick ratio are indicators of a company's short-term debt paying ability. Since 2016, these two indicators have been declining, especially in 2018 where the decline was significant. This is mainly due to the company's launch of a new round of expansion, increasing its land reserves in third - and fourth tier cities and acquiring a large amount of commercial real estate. This indicates that the company's short-term solvency is continuously weakening. From a horizontal comparison, these two short-term debt repayment ability indicators have been lower than the average of the control group for many years after 2018, indicating that Baolong Real Estate's short-term debt ratio is too high, laying hidden dangers for future defaults.

The asset liability ratio is an indicator that measures a company's long-term debt paying ability. The higher the indicator, the lower the company's long-term debt paying ability. From Table 2, it can be seen that the asset liability ratio of Baolong Real Estate has been on an overall upward trend since 2015, and has been declining since 2020 mainly due to the impact of the "three red lines" policy, forcing it to actively deleverage. Compared with the average of the control group, the asset liability ratio of Baolong Real Estate has been higher than that of the control group for many years, indicating that its financial leverage is at a relatively high level in the industry and its long-term debt paying ability is poor.

Table 3. Financing Costs and Net Profit of Baolong Real Estate

particular year	Financing cost (in billions of yuan)	Net profit (in billions of yuan)	Financing cost/net profit (%)
2012	15.02	56.59	26.53
2013	19.34	76.46	25.29
2014	12.16	65.06	18.69
2015	21.54	67.12	32.09
2016	23.67	70.56	33.55
2017	16.73	214.24	7.81
2018	52.12	87.28	59.72
2019	56.00	100.93	55.48
2020	24.09	91.46	26.34
2021	41.65	-163.53	-25.47
2022	97.27	-157.79	-61.65

The expansion of interest bearing liabilities also brings about an increase in financing costs, constantly eroding the company's profits. The proportion of financing costs to net profit of Baolong Real Estate is on a fluctuating upward trend, with a relatively small proportion in 2017. This is mainly due to the non recurring gains and losses brought about by the acquisition of Wanda hotels in 2017, which increased net profit. If this part is deducted, the proportion of financing costs to net profit has reached 20%. Even reaching over 50% at one point, it indicates that the company's financing costs are too high, eroding net profits and further weakening the company's internal financing capabilities.

In addition, there is also a mismatch in the maturity

structure of the company's debt. The debt maturity structure is usually expressed as the percentage of long-term liabilities to total liabilities, and the lower the ratio, the more inclined the company is towards short-term debt financing. The asset maturity structure is usually represented by the proportion of fixed assets to total assets, and a higher proportion indicates that the company is increasingly inclined towards long-term investment. The company's debt maturity has been continuously decreasing since 2016, indicating that the company's short-term debt financing is increasing. However, the overall asset maturity has steadily increased since 2016. The reverse trend of the two in the later stage indicates that Baolong Real Estate is increasingly relying on short-term financing for long-term investment.

In summary, in terms of debt size, Baolong Real Estate's excessive financial leverage has increased the company's default risk, and in terms of debt structure, it tends to lean towards short-term debt financing, resulting in a mismatch between debt maturity and asset maturity. After 2019, the company entered a period of concentrated debt repayment, highlighting liquidity risks. After 2020, the external financing environment continued to tighten, ultimately leading to bond defaults.

3. Conclusion

The fundamental reasons for Baolong Real Estate's default are the mistakes in its business strategy and neglect of debt management. Firstly, in terms of business strategy mistakes, firstly, heavy holdings in third - and fourth tier cities have led to the gradual sinking of land reserves towards these cities. However, from the actual sales situation, the sales of first - and second tier real estate markets have always been hotter than those of third - and fourth tier real estate markets, especially after the tightening of "shantytown monetization" in 2018. The real estate market in third - and fourth tier cities has remained sluggish, leading to increased difficulty in land conversion and gradually lower sales growth rates than the industry average. Secondly, increasing investment in commercial real estate. While Baolong Real Estate mainly focuses on residential real estate, its proportion of commercial real estate is too high, which has accumulated a large amount of funds and dragged down asset turnover speed. Especially in 2017, the company's acquisition of hotels under Wanda not only did not bring profits to the company, but also continued to incur losses, weakening the company's profitability. In addition, while expanding strategically, Baolong Real Estate did not manage its debt well, and its leverage ratio has always been at a relatively high level in the industry. There is also a problem of mismatched maturity structure. After encountering the impact of the epidemic and tightening financing policies, the early debt problems were exposed, and when the centralized redemption period arrived, it was unable to repay at maturity, ultimately leading to bond defaults.

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