Babcock & Brown: Down but not out

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Despite the appearance of a splintering bank group, on 4 December Babcock & Brown (B&B) announced it had won a reprieve from its banks – an extra A$150 million ($104 million) loan, suspension of its corporate debt covenants and conversion of scheduled interest payment to a "pay as you can" basis. Twelve banks from the 25-bank corporate syndicate put forward new funds.

The banks have taken a view that they are likely to receive a greater proportion of their money back if there is an orderly sell-down of assets rather than a fire-sale from administration. What B&B needs is time and improved debt markets to help assets sales.

The A$150 million loan has a one-year tenor, carries a margin of 600bp over 30-day bank bill swap bid rate and ranks as senior to the outstanding A$3.1 billion corporate debt facility. Missed interest payments on the existing corporate facilities (which carry a margin of 200bp), will incur an additional 200bp. No distributions can be made until the super senior debt and the additional interest on the corporate debt is repaid.

Although this is the season of goodwill, Babcock is in a weak bargaining position for a forthcoming debt for equity swap when talks begin with banks on 28 February 2009. Its position could be improved by quick divestments at fair market value. It has so far successfully managed to sell off its Spanish and Portuguese wind assets at a price close to the current market benchmark of Eu2 million per megawatt. Expressions of interest have been circulated for its wind assets in France, Germany and Greece.

Given the reputational damage to B&B, it is unlikely that it can survive as a fund manager as most of the listed funds have sought to distance themselves from their parent. B&B's revised business plan concentrates on its infrastructure business, which contributed 68% of its revenues in the last financial year, and cutting staff by two-thirds to 600. The plan is bold but probably does not go far enough; any future should be centered purely on its strength, asset development.

Under its new plan B&B would need to divest itself of its corporate and structured finance, operating lease and real estate arms that had net assets valued at A$2.7 billion at Babcock's 2007 year end. With many forced real estate sales the trade value of these divestments will have fallen sharply.

The market has already priced in significant share dilution with B&B's share price at A$0.165c on 16 December, down from A$0.25c when its shares were suspended. One consequence of removing, albeit temporarily, the corporate refinancing risk by announcing an upcoming debt to equity swap (the terms of which are unclear but will be in place by 30 April) is to keep B&B a going concern but with a heavily depressed share price. This could encourage a trade sale before a new capital structure is implemented.

Babcock's downfall was based on a number of mismatches. Most damaging has been the mismatch between short term corporate funding at B&B, BBI and BBP, versus long term infrastructure assets. Dealmakers within B&B were incentivised to close as many deals as possible to up the transaction fees paid by the funds – the short term interests of B&B employees, and B&B's share price, were not entirely aligned with the investors' interests in its funds. These transaction and management fees were tempered by independent fund directors who chose whether or not to purchase assets using independent valuations. Both Babcock and Macquarie have since sought to strengthen fund governance in light of investor criticism.

The listed infrastructure model has been shown to be unsuited to aggressively geared infrastructure funds that participate in highly leveraged acquisitions and raise debt on a project and corporate basis, such as BBI and BBP. Even if asset valuations hold up, retail investors are easily spooked by high amounts of debt, which can trigger falling share prices and which gather momentum with the participation of hedge funds shorting a stock. An almost zero market capitalistion becomes a self-fulfilling prophecy. Exactly this happened to B&B – concerns over debt led to a fall in its share price, rumours of debt covenants being breached depressed prices further, which lead to the company twice renegotiating its corporate facilities.

Some analysts have criticized Babcock's valuation models. B&B uses the industry standard discounted cash flow (DCF) model using its own aggressive discount rate inputs. This is fine when valuing assets you intend to keep, altering values as cashflow is enhanced or impaired, but now most of these assets will be brutally marked to market as B&B, BBI and BBP must sell assets to deleverage and survive. This uncertainty scares shareholders who sell.
BBP paid off its A$118 million debt facility with BBP holdings with the A$130 million sale of its interests in the Kwinana and Neerabup power stations in West Australia. It still owes its parent B&B A$375 million – A$174 million due September 09 and A$201 million due 2010. The first maturity on its A$2.47 billion corporate debt is June 2011.

BBI had its rating lowered at the end of November by Moody's to B1/B2. Moody's stated: "BBI has cash requirements in the next 3 months, without committed available facilities. These include $100 million debt due in February 2009 at the BBI corporate level." Below corporate level, $157 million is payable for BBI's remaining minority interest in WestNet Rail. BBI agreed a short-term extension to 17 December 2008 of $66 million mezzanine debt repayment that was due on 15 December 2008. BBI hopes to repay the loan from proceeds of the A$349.47 million sale of 50% of Powerco.

Babcock & Brown Wind Partners seems likely to emerge largely intact, albeit with a different name and new manager. It has no refinancing requirements and all existing development projects are funded.

Those listed infrastructure funds which match assets and liabilities, raising debt predominantly through project financings are faring relatively well. The three UK listed infra funds Babcock & Brown Partnerships, 3i Infrastructure and HSBC Infrastructure funds have avoided the same precipitous falls as other financial stocks. BBPP is trading at a discount due to the damage caused by the plight of its manager.

The root cause of Babcock's slide was the A$7.4 billion Alinta acquisition in August 2007 by Babcock & Brown and its sibling funds BBI and BBP. The plight of BBP in being unable to secure its targeted long term funding package shone a light on the potential corporate and project refinancing risk of its parent Babcock & Brown and other associated funds such as BBI, which led to a run on their shares.

As Chairman Len Gill said at BBP's AGM on 7 November: "In hindsight it is now apparent that Alinta was purchased at the end of one era and long term funding was sought at the start of another."