Brisconnections - lessons to be learned

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Today, 29 April 2009, is the day when the first instalment of the Brisconnections shareholder call is due. Each share in the troubled project, to build a link road from Brisbane city centre to the city's airport, means Aus$1 owed today - and another in January 2010.

Those payments are unlikely to be flooding in to the project's sponsors, Macquarie and Thiess John Holland. The stock has been next to worthless since November last year, leaving most investors unwilling - and many simply unable - to pay the cash calls.

The underlying Airport Link project is fundamentally a good one because it offers customers multiple purposes, namely a suburban bypass, connection to the airport and to the city. Moreover, its connectivity to the Inner City Bypass, the North-South Bypass Tunnel and the East-West Arterial ensure its potential users are far broader than simply travellers between the city and north.

It is however the structure of Brisconnections (BCS) that has led to the current predicament that the company finds itself in, which - according to Peter Doherty of Australian infrastructure investment company CP2 - "epitomises much of what has gone wrong with greenfield PPP projects in recent years".

Project background

Brisconnections, a joint venture between Macquarie Bank and two Hochtief Group construction companies, Thiess and John Holland, won the contract to build the road in May 2008.

They beat off competition from a Bilfinger Berger-led consortium, and a third consortium where another Hochtief Group company, Leighton, was supported by ABN Amro.

With institutional equity commitments made in May, a market suddenly wary of high leverage and market doubts about the traffic forecasts, BCS shares fell 59 per cent on the opening day of trading. It continued to slide down to $0.001 as the markets fell.

Most institutional shareholders, including sponsor Macquarie, sold and the dividend was all but eliminated. This impact was amplified by the partly paid structure which had a Aus$2 liability to be paid in two Aus$1 instalments over the 18 months after listing, a structure that relies on a rising asset market.

Many retail investors bought into the stock without realising that there was a liability attached and now face significant calls (Aus$1,000 of stock purchased at Aus$0.001 effectively creates a Aus$2m liability).

One stockholder, Australian Style Investments (ASI), increased its stake to 19.8 per cent and forced the management to a General Meeting of shareholders to vote on a resolution to wind up the company, as well as other resolutions such as the deferment of the second instalment and reinstatement of the dividend.

Macquarie stepped in to the market at the end of March to buy around 8 per cent of the stock such that between it and two other major shareholders they would have more than 25 per cent of the stock and could have blocked the wind-up vote.

However, with a large construction contract at risk, together with Aus$200m of deferred equity that could be called on debt default, the project construction contractor Thiess decided not to take any chances and purchased ASI's proxy votes (not the shares) for Aus$4.5m. As a consequence, all the resolutions were voted down. ASI remains liable for the first call on its 77m shares.

The deal came after 2 failed attempts by the Underwriters to stop the EGM in court, and after a deal proposed by Underwriters to make an offer to take the stock from shareholders (removing their obligation to pay the first instalment) if they voted against the wind up was blocked by the QLD government.

The timeline at a glance:

- May 2008 - institutional equity commitments made
- Jul 2008 - stock listed and fell 59 per cent on first day of trading
- September 2008 - Macquarie commenced selling down its holdings
- Nov 2008 - BCS shares drop to Aus$0.001 per share (the lowest price allowable by the ASX)
- Nov 2008 - Macquarie ceases to be a substantial shareholder
- Mar 2009 - Australian Style Investments (ASI) increased its stake to 19.8 per cent and forced the management to a General Meeting of shareholders to vote on a resolution to wind up the company, as well as other resolutions such as the deferment of the second instalment and reinstatement of the dividend
- Mar 2009 - Macquarie stepped into the market to buy around 8 per cent of the stock such that between it and two other major shareholders they would have over 25% of the stock and could have blocked the wind-up vote
- Apr 2009 - Thiess, the project construction contractor, purchased ASI's proxy votes (not the shares) for Aus$4.5m. As a consequence, all the resolutions at the General Meeting were voted down. ASI remains liable for the first call on its 77m shares

A flawed model

According to Doherty, the way the deal has been structured is a function of the bidding model used by the Queensland government, a lack of competition in the Australian construction sector, and an excessive use of financial engineering in order to aid the consortia to make a higher upfront offer.

He says: "The bidding model is generally poorly conceived, as sponsors take massive upfront fees and rewards for winning the bid as well as ongoing fee streams, while taking limited equity risk. Ultimately, this encourages aggressive assumptions and high levels of leverage. For BCS, Aus$267m in upfront fees and financing costs became payable at the time of listing, with ongoing fee streams.

"Another flaw in the model is the large bid costs, which can serve to discourage competition and result in sub-optimal outcomes for the procuring authority. For Airport Link, the consortia faced bid costs in the order of Aus$30m.

"It should be noted that construction costs in Australia also suffer from a lack of effective competition in the road construction market. One firm has been involved in 5 of the past 6 toll road construction projects in Australia (only missing out on the Cross City Tunnel). In many cases, this firm has subsidiaries apparently bidding against each other in separate consortia.

"As a consequence, there is an inherent conflict of interest between the long term sustainability of the bid company and the incentive to win the bid, which can be seen manifesting in overly optimistic traffic forecasts. In the last 10 years traffic only one toll road, Citylink, has met pre-open forecasts, with some missing by over 60 per cent.

"In the case of BCS, the traffic assumptions are more than double those in the Environmental Impact Statement. While part of this can be accounted for by design changes and new information, much of this is the use of aggressive assumptions - such as using population and employment numbers that are approximately 3.2 per cent and 8.7 per cent above the ABS medium series forecast by 2016.

"The same conflict has also led to an excessive use of financial engineering in order to aid the consortia to make a higher upfront offer. This includes the use of not only high leverage initially, the misleading representation that the investment has the ability to pay dividends whilst there are no earnings, and the use of regearing assumptions built into the bid models to maximise the notional IRR.

"It should be noted that these regears also generate significant fees for the sponsors. The high level of gearing also exacerbates the impact of reduced asset values. Ultimately, should traffic materialise significantly below the projected level, the investment bank will potentially be able to take a fee on a capital raising instead as the company needs to raise equity to pay down debt.

"Infrastructure entities have been effectively borrowing short and lending long, with the benign environment encouraging leverage and expanding valuations. As I warned in a speech I gave in February 2006, these structures which were accepted by investors in expansionary times may be found wanting under stress - as we have seen with BCS which was listed just as the full impacts of what was then called the sub-prime crisis were starting to be felt.

"Ultimately, the bid model promotes an environment in which the financial losses incurred by the finance providers (both debt and equity) are greater than the value that would be lost by system which promoted a more sustainable model with an increased cost of capital."

Looking forward

It is likely that many of the retail shareholders will default on their obligations. Under the terms of the underwriting agreement, BCS will forfeit the units of any shareholder who does not meet their obligations and will publicly auction them. BCS is also obliged to use best endeavours over six months to pursue any shortfall (BCS maintains this will involve issuing proceedings against defaulting investors).

Where the full amount cannot be recovered, the underwriters are then obliged to step in and fund the shortfall by subscribing to (or procure subscription of) additional stapled units to make up for the shortfall. Ultimately this will likely result in the underwriters controlling the company. If the company stays listed, this process could be repeated for the third instalment.

The PPP model is beneficial as it delivers material benefits to the community. However, says Doherty, "To realise the benefits of PPP the model needs to mature. This is apparent from the two central components of PPP, namely:

- government concession grantor
- private owners

"On the government side, bid models need to evolve such that advantage does not favour the larger construction firms. On the owner side there needs to be evolution to the ultimate owner controlling the bid process from the outset."