Babcock bosses let themselves down - day 3

Assessing the management team is one of the most important exercises to undertake when assessing business value. It's also notoriously difficult.

Warren Buffett once said 'In looking for someone to hire, you look for three qualities: integrity, intelligence, and energy. But the most important is integrity because if they don't have that, the other two qualities, intelligence and energy, are going to kill you.'

The problem I've experienced is that most people show integrity when the news is all good. It's when the share price starts heading south that you need to look closely (witness the number of profit upgrades since Flight Centre's attempted management buyout last year).

So what does that say about Babcock & Brown? It's easy to hurl abuse from the sidelines while the share price is getting hammered, but I'd like to hear from anyone that knows them better than me. That's pretty much anyone that's ever had anything to do with them – I've never had dealings with Babcock and I've never owned a share in the mother ship or any of the satellite funds.

From a distance, the two things in their favour are longevity and a lot of skin in the game. Run through the important executives and they've all been there a long time. On the board there's executive chairman and founder James Babcock (31 years), executive director James Fantaci (26 years) and managing director Phillip Green (24 years). The rest of the 11-person senior executive team contains three with more than 20 years experience and another three with more than 15. They're not fly-by-nighters.

And, while their pay packages look ludicrous, up to half is typically taken as shares in the business. In total, staff members own 40% of Babcock's shares and they didn't take any money off the table when the company floated in 2004 (it was all used for expansion purposes). These guys and girls care about the share price.

So why have they made such a mess of it? I normally go straight past the corporate governance section of an annual report, but the following commentary caught my attention as I flicked though Babcock's 07 Report.

'The establishment and successful operation of its specialised listed and unlisted focused investment vehicles ("Funds") is fundamental to Babcock & Brown's business model.' Then it goes on to list the potential risks to this model:

- failure of the Manager to act in the best interests of the investors of the Fund;
- lack of independence of the Fund Boards;
- restrictions imposed on the operations and decision making ability of the Fund Boards;
- failure of the Manager to properly manage related party issues and conflicts of interests, where the Manager undertakes major related party transactions with Babcock & Brown Group entities, which are ultimately paid for by the Fund with a range of fees potentially being paid to the Manager;

- the Manager may pursue growth with accompanying higher fees at the expense of the nature and risk profile of returns to fund investors;
- lack of proper oversight of the performance of the Manager; and
- lack of appropriate controls to manage these governance risks.

It almost reads as if they foresaw their own downfall. Maybe the lure of the dollar was simply too much to resist. Or maybe they really did think the banks were going to keep on lending ludicrous amounts of money forever and that you couldn’t possibly go wrong with infrastructure. Either way, the behaviour of the past few years is a black mark against what was a fairly impressive record.

Add your experiences to my limited knowledge by commenting below.