Babcock & Brown: How Bad Can It Get?

Downside analysis is one of the most important parts of any security analysis; what's the worst that can happen here? For Babcock & Brown, the answer is simple. With $2.15bn of senior debt and another $614m of unsecured noteholders queued up in front of shareholders, there is definite potential for a wipe-out.

That turns the situation into one of risk versus reward. What are the chances of it happening and what's my reward if it doesn't? The reward we'll come to in a few days' time. For now, we'll focus on the chances of a wipe-out.

We often talk chance and probability at The Intelligent Investor, but this is a lot more subjective than calculating the odds of flipping three heads in a row. Like trying to calculate the odds of global warming, this experiment won't be repeated. There's no refining your probabilities once reality unfolds and, even if you're right, you might be wrong (see Right decision, wrong result from 2003).

But that doesn't make the exercise any less important. And to make an attempt, we need to get stuck into some numbers. The balance sheet is where most things go wrong and I've reproduced the table below from the Babcock's management review in the 2007 annual report.

Babcock's 2007 balance sheet	Assets ($m)	Liabilities ($m)
Real Estate	5,447	3,667
Infrastructure	5,919	3,669
Operating Leasing	1,926	1,567
Corporate and Structure Finance	976	386
Segment Assets and Liabilities	**14,268**	**9,290**
Corporate Debt	-	2,760
Net Cash	363	-
Total	14,631	12,050

These numbers are not audited, so they need to be taken with a grain of salt. But they are much more useful than the audited numbers at the other end of the report. They show how much of the debt is 'full recourse' and which has recourse only to specific assets. If one of these assets goes bankrupt, the creditors won't have recourse to any of Babcock's other assets. Think of it as a fund manager where each investment's debt sits on the fund manager's balance sheet – you can see how leveraged the investments are but one disaster won't bring the empire crashing down.

That doesn't make it any less

Still, the $14.6bn worth of assets on Babcock's balance sheet is offset by $12.1bn of debt. If the assets were sold for 17% less than their balance sheet value – hardly a substantial markdown in the current environment – shareholders would be left grasping at thin air.

For the time being at least, though, that looks unlikely. The consortium of banks providing the $2.15bn corporate facility have waived their market-based review clause that had allowed them to put Babcock under the blowtorch if its share price fell below $7.50. They obviously think it's worth more as a fee-gouging going concern – and I wouldn't disagree.

But Babcock isn't out of the woods yet. There are, no doubt, plenty more clauses relating to interest cover and debt-to-equity ratios. If the business takes a turn for the worse, the banks will be back at the table.

It's impossible to know what most of the assets are worth or what Babcock paid for them. But, as an example, the company had listed investments sitting on its 31 December balance sheet valued at $1bn. An admittedly-stressed Mr Market is currently pricing them, in total, at around $600m. These assets won't be revalued to their current market price (believe it or not, they are valued at the board-calculated underlying net tangible asset value of the various funds), but it's a safe bet the banks are keeping a close eye on their security.

Debt waiver or not, the balance sheet leverage remains a worry. The other issue that could bring Babcock unstuck is a severe deterioration in its earnings. I'd guess the banks are comfortable with their exposure thanks to the $70bn of assets under management on which Babcock collects its fees. Even if its highly profitable asset flipping came to a screaming halt, Babcock still has some very generous management contracts locked in place.

Locked-in fees on a huge pile of debt

It's another case of 'believe it or not', but most of the contracts stipulate that the fund has to pay Babcock a percentage of enterprise value (market capitalisation plus net debt). And while the market capitalisations of its funds have been plummeting, the debt isn't going anywhere. So the fees should hold up reasonably well. I've read a number of the fund prospectuses and, while GPT Group seems to think it has a way out of its joint venture with Babcock, the rest of the funds seem to be pretty effectively tied in. Most of the management agreements are 25-year contracts and can only be terminated if there's a material breach of the contract.

So Babcock has a nice reliable stream of fees with which to service its debt. But it's unlikely to be enough. Babcock's interest bill will be something like $280m for the year and I'd guess the banks require coverage of something like three times. It might collect $400m a year in base fees, but by the time you subtract staff costs, rent and the like, it's not going to be anywhere near enough.

There's some comfort in the locked-in income (especially for the banks) but the short of it all is that we're back to where we were – as a shareholder, you need this balance sheet to be worth something and producing income. Otherwise, you'll end up with nought.

The assets are all they're cracked up to be – safe, reliable, cash-producing assets – but the amount of leverage makes it very hard to reach a confident conclusion. Unless you're buying it for a song (we're getting there, I promise), Babcock's balance sheet is one to be wary of.